Fiscal Federalism

This is Volume 65 in the series of studies commissioned as part of the research program of the Royal Commission on the Economic Union and Development Prospects for Canada.

The studies contained in this volume reflect the views of their authors and do not imply endorsement by the Chairman or Commissioners.

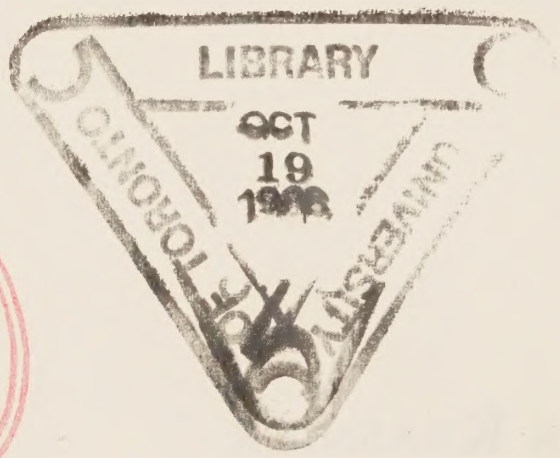
Fiscal Federalism

MARK KRASNICK
Research Coordinator

Published by the University of Toronto Press in cooperation with the Royal Commission on the Economic Union and Development Prospects for Canada and the Canadian Government Publishing Centre, Supply and Services Canada

University of Toronto Press
Toronto Buffalo London

Grateful acknowledgment is made to the following for permission to reprint previously published and unpublished material: Johann Wolfgang Goethe-Universität (*Public Finance/Finances Publiques*).



Printed in Canada
ISBN 0-8020-7312-3
ISSN 0829-2396
Cat. No. Z1-1983/1-41-65E

CANADIAN CATALOGUING IN PUBLICATION DATA

Main entry under title:
Fiscal federalism

(*The Collected research studies / Royal Commission on the Economic Union and Development Prospects for Canada,*
ISSN 0829-2396 ; 65)
Includes bibliographical references.
ISBN 0-8020-7312-3

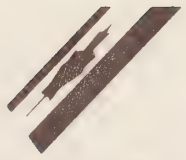
1. Federal-provincial fiscal relations — Canada — Addresses, essays, lectures. 2. Fiscal policy — Canada — Addresses, essays, lectures. I. Krasnick, Mark R. II. Royal Commission on the Economic Union and Development Prospects for Canada. III. Series: The Collected research studies (Royal Commission on the Economic Union and Development Prospects for Canada) ; 65.

HJ793.F57 1985 354.710072'52 C85-099518-3

PUBLISHING COORDINATION: Ampersand Communications Services Inc.
COVER DESIGN: Will Rueter
INTERIOR DESIGN: Brant Cowie/Artplus Limited

CONTENTS

FOREWORD



When the members of the Rowell-Sirois Commission began their collective task in 1937, very little was known about the evolution of the Canadian economy. What was known, moreover, had not been extensively analyzed by the slender cadre of social scientists of the day.

When we set out upon our task nearly 50 years later, we enjoyed a substantial advantage over our predecessors; we had a wealth of information. We inherited the work of scholars at universities across Canada and we had the benefit of the work of experts from private research institutes and publicly sponsored organizations such as the Ontario Economic Council and the Economic Council of Canada. Although there were still important gaps, our problem was not a shortage of information; it was to interrelate and integrate — to synthesize — the results of much of the information we already had.

The mandate of this Commission is unusually broad. It encompasses many of the fundamental policy issues expected to confront the people of Canada and their governments for the next several decades. The nature of the mandate also identified, in advance, the subject matter for much of the research and suggested the scope of enquiry and the need for vigorous efforts to interrelate and integrate the research disciplines. The resulting research program, therefore, is particularly noteworthy in three respects: along with original research studies, it includes survey papers which synthesize work already done in specialized fields; it avoids duplication of work which, in the judgment of the Canadian research community, has already been well done; and, considered as a whole, it is the most thorough examination of the Canadian economic, political and legal systems ever undertaken by an independent agency.

The Commission's research program was carried out under the joint

direction of three prominent and highly respected Canadian scholars: Dr. Ivan Bernier (*Law and Constitutional Issues*), Dr. Alan Cairns (*Politics and Institutions of Government*) and Dr. David C. Smith (*Economics*).

Dr. Ivan Bernier is Dean of the Faculty of Law at Laval University. Dr. Alan Cairns is former Head of the Department of Political Science at the University of British Columbia and, prior to joining the Commission, was William Lyon Mackenzie King Visiting Professor of Canadian Studies at Harvard University. Dr. David C. Smith, former Head of the Department of Economics at Queen's University in Kingston, is now Principal of that University. When Dr. Smith assumed his new responsibilities at Queen's in September 1984, he was succeeded by Dr. Kenneth Norrie of the University of Alberta and John Sargent of the federal Department of Finance, who together acted as Co-directors of Research for the concluding phase of the Economics research program.

I am confident that the efforts of the Research Directors, research coordinators and authors whose work appears in this and other volumes, have provided the community of Canadian scholars and policy makers with a series of publications that will continue to be of value for many years to come. And I hope that the value of the research program to Canadian scholarship will be enhanced by the fact that Commission research is being made available to interested readers in both English and French.

I extend my personal thanks, and that of my fellow Commissioners, to the Research Directors and those immediately associated with them in the Commission's research program. I also want to thank the members of the many research advisory groups whose counsel contributed so substantially to this undertaking.

DONALD S. MACDONALD

INTRODUCTION

At its most general level, the Royal Commission's research program has examined how the Canadian political economy can better adapt to change. As a basis of enquiry, this question reflects our belief that the future will always take us partly by surprise. Our political, legal and economic institutions should therefore be flexible enough to accommodate surprises and yet solid enough to ensure that they help us meet our future goals. This theme of an adaptive political economy led us to explore the interdependencies between political, legal and economic systems and drew our research efforts in an interdisciplinary direction.

The sheer magnitude of the research output (more than 280 separate studies in 70+ volumes) as well as its disciplinary and ideological diversity have, however, made complete integration impossible and, we have concluded, undesirable. The research output as a whole brings varying perspectives and methodologies to the study of common problems and we therefore urge readers to look beyond their particular field of interest and to explore topics across disciplines.

The three research areas, — *Law and Constitutional Issues*, under Ivan Bernier; *Politics and Institutions of Government*, under Alan Cairns; and *Economics*, under David C. Smith (co-directed with Kenneth Norrie and John Sargent for the concluding phase of the research program) — were further divided into 19 sections headed by research coordinators.

The area *Law and Constitutional Issues* has been organized into five major sections headed by the research coordinators identified below.

- Law, Society and the Economy — *Ivan Bernier and Andrée Lajoie*
- The International Legal Environment — *John J. Quinn*
- The Canadian Economic Union — *Mark Krasnick*

- Harmonization of Laws in Canada — *Ronald C.C. Cuming*
- Institutional and Constitutional Arrangements — *Clare F. Beckton and A. Wayne MacKay*

Since law in its numerous manifestations is the most fundamental means of implementing state policy, it was necessary to investigate how and when law could be mobilized most effectively to address the problems raised by the Commission's mandate. Adopting a broad perspective, researchers examined Canada's legal system from the standpoint of how law evolves as a result of social, economic and political changes and how, in turn, law brings about changes in our social, economic and political conduct.

Within *Politics and Institutions of Government*, research has been organized into seven major sections.

- Canada and the International Political Economy — *Denis Stairs and Gilbert Winham*
- State and Society in the Modern Era — *Keith Banting*
- Constitutionalism, Citizenship and Society — *Alan Cairns and Cynthia Williams*
- The Politics of Canadian Federalism — *Richard Simeon*
- Representative Institutions — *Peter Aucoin*
- The Politics of Economic Policy — *G. Bruce Doern*
- Industrial Policy — *André Blais*

This area examines a number of developments which have led Canadians to question their ability to govern themselves wisely and effectively. Many of these developments are not unique to Canada and a number of comparative studies canvass and assess how others have coped with similar problems. Within the context of the Canadian heritage of parliamentary government, federalism, a mixed economy, and a bilingual and multicultural society, the research also explores ways of rearranging the relationships of power and influence among institutions to restore and enhance the fundamental democratic principles of representativeness, responsiveness and accountability.

Economics research was organized into seven major sections.

- Macroeconomics — *John Sargent*
- Federalism and the Economic Union — *Kenneth Norrie*
- Industrial Structure — *Donald G. McFetridge*
- International Trade — *John Whalley*
- Income Distribution and Economic Security — *François Vaillancourt*
- Labour Markets and Labour Relations — *Craig Riddell*
- Economic Ideas and Social Issues — *David Laidler*

Economics research examines the allocation of Canada's human and other resources, the ways in which institutions and policies affect this

allocation, and the distribution of the gains from their use. It also considers the nature of economic development, the forces that shape our regional and industrial structure, and our economic interdependence with other countries. The thrust of the research in economics is to increase our comprehension of what determines our economic potential and how instruments of economic policy may move us closer to our future goals.

One section from each of the three research areas — The Canadian Economic Union, The Politics of Canadian Federalism, and Federalism and the Economic Union — have been blended into one unified research effort. Consequently, the volumes on Federalism and the Economic Union as well as the volume on The North are the results of an interdisciplinary research effort.

We owe a special debt to the research coordinators. Not only did they organize, assemble and analyze the many research studies and combine their major findings in overviews, but they also made substantial contributions to the Final Report. We wish to thank them for their performance, often under heavy pressure.

Unfortunately, space does not permit us to thank all members of the Commission staff individually. However, we are particularly grateful to the Chairman, The Hon. Donald S. Macdonald; the Commission's Executive Director, J. Gerald Godsoe; and the Director of Policy, Alan Nymark, all of whom were closely involved with the Research Program and played key roles in the contribution of Research to the Final Report. We wish to express our appreciation to the Commission's Administrative Advisor, Harry Stewart, for his guidance and advice, and to the Director of Publishing, Ed Matheson, who managed the research publication process. A special thanks to Jamie Benidickson, Policy Coordinator and Special Assistant to the Chairman, who played a valuable liaison role between Research and the Chairman and Commissioners. We are also grateful to our office administrator, Donna Stebbing, and to our secretarial staff, Monique Carpentier, Barbara Cowtan, Tina DeLuca, Françoise Guilbault and Marilyn Sheldon.

Finally, a well deserved thank you to our closest assistants: Jacques J.M. Shore, *Law and Constitutional Issues*; Cynthia Williams and her successor Karen Jackson, *Politics and Institutions of Government*; and I. Lilla Connidis, *Economics*. We appreciate not only their individual contribution to each research area, but also their cooperative contribution to the research program and the Commission.

Ivan Bernier
Alan Cairns
David C. Smith

PREFACE

In the Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada, volume 65 is the seventh in a series on the economic union and Canadian federalism. This series deals with the rules designed to ensure a well-functioning barrier-free economy and the institutions required to meet specific needs based on the recognition of community concerns.

Since Confederation, there has existed as well the recognition of the need for regional equity. This has often remained unstated, however, for regional equity is not easy to define, nor do the participants agree on how to make it operational. In Canada we have made regional equity synonymous with equalization, and barrier reduction has been coupled with harmonization. This volume tries to unwind and then recast some of those concepts.

One area that has caused much controversy in the last decade is that of fiscal federalism. While this statement may initially appear arguable, given our preoccupation with language and political survival, to much of the nation survival is a question of revenue sharing, a matter of control over resources and tax policy.

This point became especially clear as the present volume took shape. Questions such as the use of the spending power, the harmonization of federal and provincial taxation policy, the use of conditional and unconditional grants, provincial ownership versus national sharing, and the approach to equalization — all raised significant concerns to students of the Canadian federation.

The entrenchment of the principle of equalization in section 36 of the *Constitution Act, 1982*, brought many of these concerns to the fore. Here

was a nation entrenching a principle without stating the means to achieving the ends. One harkens back to an earlier period: at the time of the first constitution, the *BNA Act* of 1867, the nation incorporated specific amounts for per capita grants to take the place of some of the taxing prerogatives that the old independent colonies were relinquishing.

We harken back as well to the call of the Rowell-Sirois Commission (the Royal Commission on Dominion-Provincial Relations) of 1940, for here the goal of providing comparable services is first articulated as a national goal. Here as well the concept of a tax code to end interprovincial and federal-provincial competition emerges.

There is much Canadian history in the study of fiscal relations, and each of the four papers in the present volume reflects a considerable part of that history.

In the first study, on federal-provincial transfers, Robin Boadway offers a critical review of the existing arrangement, providing an examination of the economic rationale for grants and a discussion of the problems of the existing system.

The question of resource revenues is the focus of Peter Cumming's study on equitable fiscal federalism, prompting an important debate about whether — or probably more accurately, how — Canadians should share from resource rents. Does the answer depend only on where you live? Are new models available for better allocating the rents that accrue from the new golds of the 20th century?

Claude Forget's paper, on the harmonization of social policy, raises the question of national standards and the key role played by the federal government in initiating the social agenda that has structured Canada since the end of World War II. Many commentators have said that Canadian federalism has benefited from this use of the spending power; but as general programs became specific policies to which penalties for failure were attached, concerns were to emerge over whether this unwritten and untested power had gone too far.

In the final paper, on taxation policy, Anthony Sheppard reviews the constitutional framework and the criteria for tax reform and provides a thorough appraisal of the Canadian tax system.

Some commentators hold the view that fiscal arrangements are as important to a federation as are the institutions of the federation and the division of powers. We think that this volume shows this to be true in Canada. It is our hope that this series will provide some of the recommendations, analyses and proposals that will be discussed when the question is addressed once again.

There is some evidence that in that next debate the focal point will be scarcity. The robustness of our policy proposals in an era of less will be the mark of the contribution that this volume will make.

MARK KRASNICK

1

Federal-Provincial Transfers in Canada: *A Critical Review of the Existing Arrangements*

ROBIN BOADWAY

Introduction

Transfers from the federal government to the provinces have existed since Confederation. They have played a significant role in the financing of provincial public expenditures throughout the history of Canada, especially in the period since World War II. Federal-provincial grants fulfil a large number of roles, and the purpose of this paper is to review what can and ought to be expected from them and to evaluate to what extent the present system fulfils these expectations. Our concern will be primarily with the financial-economic aspects of grants rather than with political/constitutional matters; that is, we shall be concentrating on the economic rationale for transfers and their financial consequences for the two levels of government rather than on the political debates as to whether, for example, grants should be used by the federal government to influence spending decisions in areas of provincial jurisdiction. Our discussion will be limited to grants from the federal government to the provinces, although there exist other sorts of grants including federal-municipal grants, provincial-local grants and grants from the federal government to the territories. Many of the same principles of grants discussed in this paper would be applicable to these kinds of grants.

Grants may be used for a variety of purposes, and there exists a corresponding variety of types of grants. For future reference, we summarize here the characteristics of different grants. Grants may be unconditional or conditional. Unconditional grants are those that may be used for any purpose (including the reduction of provincial tax rates) by the recipient province. Conditional grants are intended to be used for particular purposes or types of expenditures. They may be specific condi-

tional grants to be used for a specific type of activity (e.g., the financing of highways, hospitals or universities); or, they may be block conditional grants to finance expenditures in a general but defined area, while leaving considerable discretion to the recipient over the allocation of funds within the general area. This distinction between specific and block conditional grants is a conceptual one only and simply refers to the fact that conditional grants differ in the degree to which they must be used for specific types of expenditure programs.

Conditional grants may or may not be matching. That is, their magnitude may be contingent on the amount spent by the recipient. If the matching rate is x percent, the federal government will finance x percent of the expenditures undertaken by a province on the designated activity. In Canada, the matching formula used to determine each province's grant has, for some types of grants, been taken to apply not to the expenditures in the recipient province but to the expenditures of all provinces combined. Thus, a province's grant is x percent of national per capita expenditures multiplied by the province's population. This sort of matching formula has important behavioural consequences since the ability of an individual province to influence the size of its grant is significantly diluted. Under an ordinary matching grant, each additional dollar of expenditure by a province yields an additional federal grant of $\frac{\$x}{(1 - x)}$. For example, if $x = 0.5$, $\frac{\$x}{(1 - x)}$ is \$1.

Thus, the federal government matches each province's expenditures dollar for dollar. However, if the matching formula applies to all provinces collectively, an additional dollar spent by one province gives rise to the federal government's transferring $\frac{\$x}{(1 - x)}$, but the transfer is spread over all provinces.

Conditional grants may also be subject to an upper limit. If so, they are said to be closed-ended. Those with no limit are open-ended. These two types of grants may have very different incentive effects. If a matching grant is closed-ended, then once the limit has been reached, additional dollars spent by the province give rise to no additional grant. From the recipient province's point of view, it is just as if the grant were non-matching.

For grants that are not matching, whether they be conditional or unconditional, there must be some formula to determine the size of the grant. The formula determines how much is to be transferred in a particular year, how the grant will change over time and how the amount transferred will vary over provinces. There are a large number of potential factors that could be, and have been, used to determine the size of a grant. The simplest grant might be one of equal per capita amounts to each province. The grant could then be allowed to grow at a particular rate — for example, at the rate of growth of GNP. Another reasonably simple method of determining the size of a grant is by the so-called

principle of derivation. According to this principle, the grant to a province from a particular federal revenue source is given according to the proportion of the revenue actually collected in the province. One simple case of this is the transfer of tax points from the federal government to the provinces. (The use of this is discussed in the following sections.) Many grants incorporate more complicated factors into their structures. The grant to a province may depend upon the magnitude of one or more tax bases of the province relative to that in the other provinces — referred to as the tax capacity of the province. The equalization scheme disburses funds according to provincial tax capacities. The formula may incorporate elements of the relative costs of financing public services, or of the relative needs for public services among provinces. For example, the grant for highway expenditures may vary with kilometres of road per capita. The grant size by province may also depend upon some macro-indicator such as income per capita. These various factors have all been advocated in the literature at one time or another.

One final characteristic of grants is important in discussing the financial consequences of federal-provincial transfers. In financing the grants, the federal government will have to raise revenues from its own sources. These could be from general tax revenues or from increases in tax rates on particular tax bases. In evaluating the consequences of various grants for the provinces, it is useful to know not only the pattern of grant transfers across provinces, but also the net effect after accounting for the incidence of tax revenues across provinces.

The following section presents a survey of the economic arguments for grants. This is followed by an evaluation of the existing structure of federal-provincial grants in view of their economic rationale. Special attention is given to the proposals of the two major policy documents that have appeared in recent years: the report of the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements of August 1981 titled *Fiscal Federalism in Canada*, hereinafter referred to as the Breau Report; and the Economic Council of Canada's 1982 report titled *Financing Confederation*, hereinafter referred to as the ECC Report.

The Economic Rationale for Grants

The problem of intergovernmental grants is unique to federal states and arises because of the consequences of decentralized and independent responsibilities and decisions taken by lower levels of government. The need for intergovernmental grants obviously never arises in a unitary state in which all decisions are taken centrally by one government. Tax and expenditure policies tend to be uniformly applied throughout a unitary state, which is not the case in a decentralized federation. This distinction, though obvious, is worth bearing in mind in what follows. The unitary state will serve as a useful benchmark against which to judge

the need for grants. Much of the economics literature is devoted to devising a set of federal-provincial grants which will allow the federation of decentralized decision makers to replicate the financial consequences of a unitary state, while at the same time reaping the benefits of decentralized decision making. These latter include the ability to cater to the specific tastes of local residents and the efficiencies that may result from decentralized responsibility for budgetary decisions (including those arising from decisions taken by political institutions "closer" to the people).

In the economics literature,[1] one can discern four general types of arguments for federal-provincial grants, each of which is applicable to the Canadian case. These arguments are the existence of a fiscal gap, fiscal inequity, fiscal inefficiency and interprovincial spillovers. This section analyzes each of these rationales and considers the type of grant most appropriate to each.

The Fiscal Gap

The existence of federal-provincial transfers implies that the federal government is raising more revenue relative to its expenditure responsibilities than are the provinces. It is argued that this may reflect, in part, a structural imbalance in a federal system of government between expenditure responsibilities on the one hand and revenue-raising capabilities on the other. This differential is sometimes referred to as the fiscal gap, or the existence of vertical imbalance. Of all the arguments for federal-provincial grants, this is the most difficult to substantiate and quantify.

The magnitude of this imbalance depends upon both the desired level of provincial expenditures and the relative ability of the provinces to raise revenues compared with the federal government. Both of these are judgmental. One possible indicator of the existence of vertical imbalance would be the persistence of larger structural deficits at one level of government than at the other. The ECC Report considered the question of whether there existed a difference in structural deficits in Canada. The report did so in the context of evaluating the claim of the federal government that the magnitude of federal-provincial grants would have to be restrained as part of a more general policy of reducing the federal deficit. It argued, first, that since both levels of government had access to all major revenue sources, there could not technically exist a structural fiscal imbalance. If one level was in imbalance, all it had to do was to adjust tax rates appropriately. The ECC Report also investigated the question of whether federal transfers to the provinces had contributed inordinately to recent federal deficits, and it found that such transfers accounted for a roughly constant proportion of federal expenditures in the period 1975–81. Transfers were, therefore, not the cause of

the federal deficit. The report argued, on the basis of this, that the vertical imbalance argument should not be used to justify a reduction in federal transfers.

In this context, let us consider some of the economic arguments concerning vertical fiscal imbalance. The fact is that the magnitude of federal-provincial grants is large relative to provincial expenditures. What economic arguments can be given for the federal government financing such a large share of provincial spending?

In the Canadian context, the vertical imbalance argument could be taken to imply that, given the heavy expenditure responsibilities of the provinces, especially in the areas of health, education and welfare, if the provinces were left to themselves to finance these items out of their own revenue sources, they would not be able to fund them in an efficient manner. Either the expenditures on such services would be below the socially desirable level, or the tax structure would be inefficient. Since the arguments basically revolve around the ability of the provinces to raise revenues, it is worth presenting a catalogue of the potential limitations on the ability of the provinces to raise revenues efficiently.

Constitutional Limitations

One potential source of problems could be that the constitutional assignment of taxing powers does not match the constitutional assignment of expenditure responsibilities. For example, the *Constitution Act, 1867*, limits provinces to raising direct taxes but allows the federal government access to any tax source. The judicial interpretation of this stricture has been such as to allow provinces to gain access to most types of taxes. They do, for example, levy general retail sales taxes as well as specific commodity taxes, both of which might be construed by economists to be indirect taxes. Similarly, resource revenues can be viewed as a form of production tax — also an indirect tax, from an economist's viewpoint. Combining these with the lucrative income taxes on individuals and corporations gives the provinces access to virtually all major tax bases. Constitutional limitations on taxing powers per se do not seem to be a constraining factor that would lead to a fiscal gap. If any level of government is impeded by its limitation on entering alternative tax fields, it is probably the local level which, by and large, is restricted to property taxation.

Tax Competition

The limitations on the ability of provinces to raise taxes may be economic rather than constitutional. The argument is that certain types of resources (such as labour and capital) are mobile across provinces in a

federation and will respond to differential tax rates in determining their province of location. This being the case, provinces acting in an uncoordinated fashion will tend to bid down tax rates in an attempt to attract resources away from the other provinces. These policies, like all beggar-thy-neighbour policies, will ultimately be self-defeating if all provinces behave in a similar way. In the end, provincial tax rates would all tend to be too low and, therefore, the level of government expenditures would also be low.[2]

While this line of argument has a prima facie plausibility about it, it has not been convincingly established even in theoretical models. It is fairly easy to construct reasonable models of decentralized federations in which local governments behave perfectly efficiently.[3] Moreover, by allowing for the possibility of "tax exporting," it is possible to have local jurisdictions overspending rather than underspending. Tax exporting means provincial taxes are borne by non-residents, either because non-residents own some of the property being taxed (in the case of source-based taxes on property income), or because excise or source-based taxes are partly shifted to higher output prices on commodities that may be purchased by non-residents.

In any case, given the conflicting stories that can be told, it is difficult to base the case for substantial federal-provincial transfers on the phenomenon of tax competition. Nor does it seem to be what has motivated policy makers in the past.

Co-occupied Tax Fields

The major tax bases are used by both the federal and provincial governments. These include the personal income tax, the corporation income tax, payroll taxes and the various sales and excise taxes. The exceptions to this rule are the tariff, which is a relatively minor revenue source for the federal government, and resource and property taxes, which are major revenue sources for provincial and municipal governments. Thus, if anything, the availability of tax bases favours (at least some) lower rather than higher levels of government. The fact that both the federal government and the provinces occupy the lucrative income and commodity tax fields implies that, in addition to any competition or conflict that may exist among the provinces, competiton also exists between the federal government and the provinces. This conflict concerns the manner in which the tax capacity of a particular tax base is shared between the two levels; or, to use the common jargon, the way in which tax room is apportioned.

Historically, the resolution of the conflict over tax room has probably been more of a factor in determining the nature and magnitude of federal-provincial grants than any other. During World War II the provinces agreed to vacate the personal and corporate income tax fields in favour

of the federal government. In the immediate postwar period the federal government continued to occupy these fields but compensated the provinces for revenues collected in their jurisdictions by means of tax rental agreements. Over the years, the federal government has gradually provided more tax room to the provinces but has continued to occupy enough of the tax room to finance the large transfer programs that have been instituted, including equalization, the Canada Assistance Plan, other conditional grants and Established Programs Financing (EPF). In analyzing the system of grants that has evolved over the postwar period, it is important not to lose sight of this historical evolution. The fact that the federal government had already occupied a large share of the tax room made possible the massive transfer programs that occurred. One could argue that the real issue over the years has been the manner in which the federal government should make funds available to the provinces: via the surrender of tax room or via various sorts of grants.

Surprisingly little analysis has been undertaken concerning the conflict between the federal government and the provinces over the allocation of tax room. The process could be viewed partly as a cooperative game of close to zero sum or, also partly, as a non-cooperative (competitive) game, since the federal government is dealing with ten separate provinces. In the latter case, the federal government could be seen as having a stronger bargaining position. The strength of the federal bargaining power could be taken as giving it some power to pre-empt its desired level of expenditures as well as to transfer funds to the provinces in the manner that serves its interests. The justification for the federal government's wishing to collect taxes on behalf of the provinces and to transfer funds to them lies in the arguments of the rest of this section.

With the federal government having pre-empted its share of the tax room and having determined the amount of transfers to the provinces more or less unilaterally, the provinces are then left to choose, in a decentralized manner, their desired tax rates. This view of the process as one in which the federal government essentially determines the magnitude of federal-provincial grants by its decision as to how much of the tax room to pre-empt is, of course, refutable by the evidence. No analysis of it has been done to date. What is important to recognize at the outset, however, is that, because of the co-occupancy of the major tax fields by the two levels of government, it would always be a feasible policy option for the federal government to transfer tax room to the provinces rather than to transfer funds through grants. The federal government has chosen not to pursue that option. If it did, it could be argued that the fiscal gap would be eliminated. In evaluating the system of transfers, it will be useful to ask whether or not it would be socially desirable for the federal government to substitute tax room (or tax points) for any of the existing transfers, or whether the nature of the transfers themselves justifies their existence. In fact, as we shall argue below, from a purely

financial point of view, there would be little difference to the provinces if the federal government were to substitute tax points for the existing EPF transfers. This is because of the fact that when the tax points are equalized, they are turned into nearly equal per capita grants. This means that the only rationale for having EPF transfers is the leverage they give the federal government over the spending decisions of the provinces.

Coordination of Tax Bases

The appropriateness of viewing the transfer of tax room as equivalent to federal-provincial grants is contingent upon the uniformity of the tax structures of the federal and provincial levels of government. This uniformity owes a great deal to the Tax Collection Agreements, which themselves may be viewed as a particular form of federal-provincial transfer. Under the Tax Collection Agreements, the federal government agrees to collect taxes on behalf of the provinces provided the provinces adhere to the same definition of the tax base as the federal government and, in the case of the personal income tax, to the same rate structure. The agreements also rely on a formula for allocating to the provinces the provincial share of the taxes collected by firms operating in several provinces. The coordination of bases, the existence of a common allocation formula and the centralized collection of tax revenues all contribute to an efficiently operating federal economy.

In conclusion, it is probably not sensible to view the existence of a fiscal gap of a given amount as an exogenous concept that characterizes the Canadian federation. Instead, since both the federal government and the provinces co-occupy the major tax bases, and since the federal government can probably be seen as pre-empting its desired share of the tax room from these sources, the amount of vertical imbalance is the outcome of the resolution of the conflict over tax room. The federal government plays a primary role in deciding what share of the tax room to retain for itself and at the same time decides how much to transfer to the provinces in forms other than tax room. Thus, vertical imbalance is very much an endogenous concept determined mainly by the perceived need for federal-provincial transfers on other grounds. To these other grounds we now turn.

Fiscal Inequity

The Tax Collection Agreements involve the federal government's transferring funds to the provinces in the same amounts as if the provinces themselves had raised the revenues. That is, they obey the principle of derivation. Other transfer programs are not of this type. They typically transfer funds to the provinces in proportions different from those in

which their financing has been raised by the federal government; that is, the transfers redistribute funds among provinces. The question is: why should this be necessary? This subsection and the following two provide an answer to this question.

Economists take as the ultimate objective of economic activity the improvement of the welfare of individuals in society. According to that view, any intergovernmental transfers ought to be judged according to their usefulness in improving individual welfare. Furthermore, the transfers ought to be judged relative to other sorts of policy instruments that may be actually or potentially available. Economists usually identify a set of criteria against which to judge policies, and which themselves are thought to contribute to social welfare in the broader sense. Two of the most commonly used criteria are equity and efficiency. The criterion of efficiency is the simplest of these to use, since it requires minimal value judgements and can often be implemented on the basis of observed market prices. The economy as a whole, or a particular market, is operating efficiently if all gains from trade have been exploited; that is, if it is not possible to change the allocation of resources in the economy or in the market so as to make all persons better off. We consider the use of federal-provincial transfers to improve the efficiency of the economy in the next subsection of this paper.

The criterion of equity is somewhat more difficult to apply since it involves making interpersonal comparisons of welfare. Most policy changes involve making some persons better off and others worse off. Loosely speaking, a change is said to be beneficial on equity grounds if those who gain from the move obtain more utility per dollar of gain than those who lose from the move. To be able to apply this criterion involves making a comparison between the marginal utilities of various individuals.

Public finance economists often find it useful when judging policies to disaggregate the equity criterion into two components: horizontal equity and vertical equity. Government policy is said to be horizontally equitable if it "treats equals equally"; that is, if those who would be equally well-off in the absence of the policy are equally well-off in its presence. There are all sorts of difficulties with implementing the criterion of horizontal equity, most stemming from the difficulties of establishing when two persons are equally well-off. To do so requires making interpersonal comparisons of utility levels. The tax system does this by assuming that two persons with the same taxable income are equally well-off for tax purposes. More generally, some ideal norm such as comprehensive income is used as an index of individual well-being.[4] It ought to be recognized that accepting the principle of horizontal equity itself involves a value judgment. However, horizontal equity is a criterion that is widely accepted for tax policy purposes and for that reason is a suitable norm for the analysis of fiscal inequity. As we shall see, fiscal inequity is simply a special application of the notion of horizontal

inequity. Vertical equity concerns the appropriate way to treat persons with different levels of utility and is of prime concern in judging the progressivity of the tax system. Fortunately, the criterion of horizontal equity is all that is needed to make the case for federal-provincial grants, not vertical equity.

The system of taxes and transfer applying to individuals is one method by which the government pursues equity goals. The base and rate structure of the personal income tax, for example, are designed, at least in principle, to reflect society's norms of horizontal and vertical equity. Horizontal equity is pursued by adjusting the tax base for such things as family size, medical expenses, education expenses and the cost of earning income. Vertical equity is achieved by the choice of a rate structure, bearing in mind that there is likely to be a trade-off between vertical equity and efficiency that tempers the ability to achieve full vertical equity.

In discussing the equity rationale for intergovernmental grants, the essential question to be addressed is: Why not rely solely on interpersonal taxes and transfers to achieve equity? Since it is the distribution of individual welfare that is at stake, why not pursue it directly through the existing tax-transfer system rather than relying on intergovernmental grants as well? The answer to this question lies in the recognition that, in the absence of intergovernmental transfers, the federal income tax applied uniformly across the federation will systematically violate the norm of horizontal equity. Identical persons in different provinces will be treated differently by the tax system. This difference arises because the federal tax base does not fully capture the real incomes of persons, in particular the real income generated by provincial government budgetary actions. In principle, this anomaly could be corrected by a federal income tax whose rate structure varied across provinces. However, there are reasons of administrative ease, jurisdictional incentive and initiative, and political expediency for a system of intergovernmental grants being preferred. In the following discussion, we shall explain why horizontal inequities result in a decentralized federation and how intergovernmental grants can be used to correct for them.

There are two main reasons for the persistence of horizontal inequities in a federal system of government. The first reason is that the fiscal actions of provincial governments give rise to net benefits to provincial residents, the magnitude of which may vary across provinces for otherwise identical individuals.[5] The second reason is that the federal income tax system, which is the main vehicle for redistributing income among persons, may not include in its base some of the net benefits of provincial government expenditures. As a consequence of these two problems, the combined tax-transfer system of the provincial and federal governments is horizontally inequitable. In reviewing this issue, it is useful first to

enumerate the various sources of horizontal inequity and then to consider appropriate ways of eliminating them.

Sources of Horizontal Inequities

Horizontal inequities result from the existence of net fiscal benefits arising from the budgetary actions of provincial governments. We refer to these as fiscal inequities. The term net fiscal benefit (hereinafter denoted NFB) refers to the difference between the value of public services received by taxpayers and the tax they pay. NFBs also arise out of the actions of the federal government, but the presumption is that they are uniformly distributed across the nation, or at least do not vary systematically by province. As a benchmark it is useful to describe a situation in which there are no fiscal inequities and then consider cases in which provincial budgets may cause deviations from this. If all provinces provided quasi-private goods at equal per capita costs and financed them by benefit taxes levied on residents, there would be no NFBs according to the way in which we are using that term (i.e., ignoring consumer surplus). Therefore, there would be no NFB differentials across provinces. At the same time, the federal income tax base, which is personal income gross-of-provincial-income-taxes, would adequately represent the real income of persons in the economy. To see this, we can rewrite taxable income as follows:

$$\begin{aligned} \text{Taxable Income} &= \text{Gross income} - \text{provincial taxes} + \text{provincial expenditures} \\ &= \text{Private goods purchased} + \text{public services consumed.} \end{aligned}$$

In this case, the federal income tax would be horizontally equitable across provinces in the sense that persons in different provinces with the same real income would pay the same federal taxes.

There are several reasons why provincial budgets may give rise to differential NFBs and/or why the federal tax base may not properly account for the real income accruing to households from the activities of the provincial governments. They include the following.

Source-based Taxation

The use of source-based taxation rather than residence-based taxation by provinces can give rise to both these difficulties. Source-based taxes are taxes levied on income where it is generated. Examples are the corporate income tax and resource taxes. If provinces finance some of their expenditures by source-based taxes, the federal personal income tax will understate personal incomes by an amount equal to the benefits accruing to provincial residents from the per capita expenditures financed by source-based taxes. That is, taxable income equals net

income plus provincial expenditures financed by personal taxes; it does not include those financed by source-based taxes. To the extent that source-based tax collections per capita vary across provinces, the federal income tax system will be horizontally inequitable in the sense that identical persons residing in different provinces will be treated differently. In particular, persons in provinces with higher source-based taxes will be favoured.

Provincial Redistributive Policies

Another main source of NFB differentials is the existence of redistributive provincial tax-expenditure systems. Consider the simple case in which provinces levy proportional income taxes in order to provide a given level of equal per capita benefits to their own residents. In this case, the rate of tax required to produce a given level of services will be higher in provinces with lower per capita incomes. In fact, if provinces wished to provide identical per capita public services, the NFB differences over provinces would just equal per capita differences in per capita income tax collections. If the tax were more progressive than this, the NFB differentials would exceed the difference in per capita tax collections and vice versa. The existence of non-neutral provincial budgets will therefore give rise to horizontal inequities. These NFBs would not exist in a unitary state which provided a uniform level of services to all residents and financed them by a uniform tax system applied to all residents. Furthermore, these NFBs arising out of provincial government redistributive policies are not captured in the federal income tax base so the latter will itself be horizontally inequitable.

Other Taxes

So far, the discussion has centred on the provincial personal income tax and on source-based taxes like the corporate income tax and resource taxes. Provinces and their municipalities do use other taxes such as indirect (commodity) taxes and property taxes. The same principles can be used to analyze the horizontal inequities caused by these taxes. Consider indirect taxes, which include both provincial sales taxes and excise taxes. If these taxes are shifted to consumers as higher prices, and if they are incident on residents, they are basically residence-based taxes. They give rise to NFBs only to the extent that they are redistributive. If they are incident on residents, which seems plausible, and if they are roughly proportional to income, they are then equivalent to a proportional income tax. If they are used to finance equal per capita benefits, they give rise to NFB differentials equal to differentials in per capita tax collections. If indirect taxes are not shifted, but instead are incident on producers, they are equivalent to source-based taxes and give rise to NFBs.

Similarly, property taxes can be categorized according to their inci-

dence. Residential property taxes are quite similar to indirect taxes. If they are shifted forward to consumers of housing services, they are like residence-based taxes. For non-residential property taxes, the same applies. If borne by firms, they are like source-based taxes. If shifted forward to consumers of the firms' products, they are like residence-based taxes.

Provision of Infrastructure

Provincial public expenditures may be used to provide public services to firms rather than to resident households. If these public services enable firms to produce goods at a lower price, the result is equivalent to the case in which the government provides public services directly to residents. On the other hand, if the public services simply go to produce higher factor incomes for non-residents, no NFBs are generated so no corrective action is needed. If higher factor incomes are provided to residents, this represents a benefit to residents from provincial government activity that may well vary from province to province, but it is one which is captured in the federal tax base.

Crown Corporation Pricing Policies

Provincial Crown corporations are often involved in production activities that produce significant economic rents, such as hydro-electric utilities. These rents may be captured and reflected as the profits of Crown corporations. Since these profits may be used to provide public services to residents, they can give rise to NFB differentials. In addition, these benefits would not be reflected in the tax base used for the federal income tax. Thus, horizontal inequities arise on both counts.

The same sort of problem arises if the rents are not captured as the profits of the Crown corporation but are dissipated as lower prices to residents for the consumption of the output produced. The ECC Report argued that significant rents accrue to residents of hydro-producing provinces in the form of lower prices. These lower prices ought to be viewed as NFBs in exactly the same way as are other provincial public services. These NFBs are likely to differ from one province to another and are not captured in the federal income tax base.

Provincial Public Services' Costs

Two provinces may incur different costs to provide identical public services. This is a source of horizontal inequity, since two persons with identical incomes and tax bills could receive different provincial public services. The difficulty in accounting for this source of inequity is that it is difficult to measure. There is no obvious reason why it should be correlated with per capita incomes or tax collections. Elements of cost differences are often used in particular types of grant programs where the costs can be readily identified.

Provincial Government Savings

Not all provincial revenues are used to provide current services. Some are saved and used to provide future services. An example of this is the Heritage Fund set up by the Alberta government.[6] In principle, the saving of revenues implies that currently no NFB differentials are being created, therefore, no corrective action is needed. However, NFB differentials will exist in the future when the funds are drawn upon. At that time, horizontal inequities will be created that need to be corrected. In fact, treating current saving that goes to produce future NFBs as if it were providing current NFBs presents no great problems in principle. The present value of the future NFBs created by provincial government saving is equivalent to the actual amount of saving now being done. Thus, treating current saving as if it were producing provincial services for residents should not cause any economic difficulty.

This concludes our survey of the sources of horizontal inequities. We now turn to a consideration of what policy measures would properly correct for these inequities.

The Correction of Horizontal Inequities

As mentioned above, the horizontal inequities that arise in a federal system of government do so from two sources: those that result from the generation of different sized NFBs by different provincial governments, and those inherent in the federal income tax because some of the real income accruing from provincial public services is not included in the federal income tax base. Before considering how one might correct for these, it is worth considering, first, whether or not they ought to be fully corrected, and this depends on the normative view one takes of horizontal equity in a federal state. There are two notions of horizontal equity to which the federal government could adhere in a federal system of government. Following the Economic Council of Canada (ECC) these are called the broad-based and the narrow-based views of horizontal equity.

Recall that the principle of horizontal equity dictates that if two persons are equally well-off in the absence of government policy, they should remain so after the policy is in place. Any policy that satisfies this principle is said to be horizontally equitable. In a federal system of government, from the federal government's point of view, the benchmark pregovernment situation could refer to one of two things. It could refer to the situation in the absence of both the provincial and federal governments, or it could refer to the situation after the provincial government budgets are in place but before the federal budget is. In the former case, the federal government is said to adhere to a broad-based view of horizontal equity, and in the latter to a narrow-based view. If the federal government takes the broad-based view of horizontal equity, its policy instruments must completely undo the horizontal inequities aris-

ing in a federal system. That is, all NFB differentials must be eliminated. If they adhere to the narrow-based view, they need only ensure that persons otherwise equal in the presence of provincial government policies remain so when federal policies are superimposed. Let us consider the appropriate federal grant policy in each of the two cases.

Broad-based Horizontal Equity

Ideally, the federal government, in pursuing broad-based horizontal equity, would seek to eliminate all differences in provincially imposed NFBs. As we have seen, the extent of NFB differentials depends upon the characteristics of provincial government policy and on the way in which the economy operates (the incidence of taxes, etc.). For example, if provincial government budgets were distributionally neutral, and if source-based taxes were incident on foreigners on average, the federal government would like to equalize differences in source-based tax collections. In principle, this could be done by a system of interpersonal transfers. However, there are two reasons why this might not be the desirable method. First, if the federal government tried to equalize all interpersonal differences in per capita source-based tax collections, there would be a great disincentive against provinces using source-based taxes, since such tax collections would implicitly be subject to a very high marginal tax rate. The second reason why a system of interpersonal transfers might not be preferred, and this applies more to the case of residence-based taxes, is the constitutional reason that the federal government may not wish to undo the redistributive actions of the provinces that give rise to some of the NFBs in the first place. They may wish to redistribute revenues in such a way as to provide the provinces with the financial capability of conforming to nationwide horizontal equity but allowing them some leeway within that to conduct their own redistributive policies. There is, thus, no advantage to using interpersonal as opposed to intergovernmental transfers, and the latter are presumably easier to administer.

In determining the system of federal-provincial transfers, it is desirable that the system eliminates NFB differentials without setting up incentives for the provinces to exploit it by tax changes. One way to do this is to equalize tax capacity rather than tax revenue. It can be shown that, if all provinces behave in an identical manner when faced with the same budget opportunities, equalizing tax capacities will then have the same effect as equalizing actual taxes without imposing the disincentive effects. In other words, the provinces will behave as if the system of government were unitary rather than federal.

The exact tax bases to be equalized and the extent of the equalization depends upon the economic circumstances. For example, if the public services provided by provinces are quasi-private goods and yield equal per capita benefits to all residents, and if source-based taxes are, on

average, incident on foreigners, source-based tax capacities should be fully equalized.[7] If residence-based taxes (income tax, sales and excise taxes, residential property tax and payroll taxes) are roughly proportional to income, they too should be fully equalized. Thus, all tax capacities should be fully equalized across provinces. This prescription is based on a reasonable set of assumptions and one accepted by the ECC. However, other sets of assumptions will give rise to other policy prescriptions, in particular to less than or more than full equalization of some tax bases.

If tax capacities are fully equalized, provinces will have the potential to eliminate all NFB differentials and will do so if they all behave identically. In this case, the federal tax system will also be horizontally equitable in the broad sense. However, in general, the federal fiscal system will be only potentially horizontally equitable. If the provinces adopt different budget policies, there will be nothing the federal government can do to correct for the resultant horizontal inequities short of overriding the discretion the provinces have to determine their own tax-expenditure policies. Some amount of horizontal inequity will be one of the costs of a federal system of government.

As mentioned, if provinces do behave uniformly, the general result of a fully equalized tax system will be equivalent to having all budgetary decisions taken centrally in a unitary state. Thus, full equalization can be viewed as a method for pursuing nationwide horizontal equity but retaining one of the main advantages of a federal state, decentralized decision making.

Narrow-based Horizontal Equity

In this case, the federal government takes as given the real incomes achieved by residents in various provinces inclusive of the NFBs generated by provincial government actions. The federal government is concerned only that its own budgetary policies be horizontally equitable. One way to view this is in terms of "property rights." With the narrow-based view, provincial residents are seen as having full property rights to the NFBs generated by their provincial governments. The only concern of the federal government in this case is to ensure that its income base treats as equals persons residing in different provinces who have the same real income, where the real incomes could include differing amounts of provincial public services.

As discussed above, the benefits of provincial public services financed by source-based taxes are left out of the definition of income for tax purposes (regardless of their incidence). In principle, these benefits ought to be taxed at the federal tax rate in the hands of recipients. The equivalent of this can be achieved at least potentially by equalizing a proportion of source-based taxes where the proportion is given by the average federal tax rate (say, 30 percent). For residence-based taxes,

NFBs are present to the extent that these taxes introduce progressivity into the budget. As before, these NFBs represent sources of real income that are not captured by the federal tax base and so escape federal taxation. However, as discussed in the ECC Report, federal-provincial grants can do nothing to correct for this. The NFBs arising from the redistributive effects of provincial budgets represent gains by some residents and losses to others, but for each province in aggregate no net NFBs result. Only a complex set of interindividual transfers can correct for this source of inequity, and they can be ruled out on the grounds that the appropriate set would involve the federal government undoing part of the redistributive actions of the provinces.

It is possible for the federal government to take a hybrid view of horizontal equity; that is, to use the narrow-based version with respect to some tax bases and the broad-based version with respect to others. The ECC argued for precisely that, taking the view that where no property rights to NFBs were guaranteed to the provinces by the Constitution, the broad-based view should be taken. Only if the Constitution stipulated provincial property rights should the narrow-based view be taken. This led the ECC to recommend that the narrow-based view be taken with respect to resource revenues, since the Constitution deemed them to be provincially owned. For all other tax sources, the broad-based view should be taken. The ECC suggested that the ideal scheme should fully equalize all non-resource revenue sources, plus all Crown corporation profits. Only a proportion of resource revenues (including hydro-electricity rents) ought to be equalized, the proportion being given by the average federal tax rate.

Finally, it should be noted that intergovernmental transfers for the purpose of correcting horizontal inequities should be unconditional. The ideal system would be a so-called net scheme; that is, tax capacities should be equalized by provinces with above-average tax capacities giving transfers to provinces with below-average tax capacities. The appropriate formula would be the national-average tax approach used until 1983 but broadened to include all revenue sources. In such a scheme, the federal government incurs no net cost. As an alternative, the federal government could collect all tax revenues on behalf of the provinces and turn them over to the provinces as equal per capita unconditional grants.

Fiscal Inefficiency

The term fiscal inefficiency refers to the misallocation of resources among provinces in a federation as a consequence of the tax-expenditure decisions taken by the provinces. This inefficiency can be characterized as a situation in which the value of the marginal product of a factor of production varies systematically according to province of use. The

factor may be capital, in which case its before-tax rate of return varies across provinces. This is most likely to be due to the varying tax treatment of capital income. The misallocation of capital by jurisdiction has not been viewed in the literature as a rationale for intergovernmental grants, although similar arguments could be applied to it as in the case of labour, and a system of corrective grants could readily be devised. Such grants might be considered an unnecessary intrusion into the discretionary powers of the provinces. Almost all of the literature has concentrated on the inefficiency of the allocation of labour among provinces as a result of provincial fiscal activities.[8]

In the absence of taxes and assuming competitive labour markets, wage rates correspond to the value of the marginal product of labour. Workers will respond to wage-rate differentials in deciding on their province of residence. In this manner, if there were no migration costs, workers would allocate themselves across provinces in such a way that the values of their marginal products would be equated. This would be an efficient allocation of labour. If there were costs of migration, the differences in the values of marginal products in equilibrium would just reflect migration costs for the marginal workers and, again, there would be an efficient allocation of labour. In an economy with a federal system of government, this correspondence between the rewards to labour in various locations and the values of the marginal product of labour is upset by the existence of NFB differentials. There is an incentive for workers to migrate from provinces with relatively low NFBs to those with relatively high NFBs because the NFB is a reward to be obtained from provincial government activities on the basis of residence alone. This incentive is independent of the presence of migration costs. The magnitude of the latter determines the extent to which the incentive to relocate will actually give rise to inefficiencies.

The same sorts of NFBs that give rise to fiscal inequities of the broad-based type also induce inefficient migration. For example, suppose that one province has a relatively large base for a source-based tax, such as a natural resource. The taxation of that resource for the purpose of financing provincial public services gives rise to NFBs to the extent that the source-based tax is incident on foreigners and the public service is for the benefit of residents. Similarly, NFBs can arise from other source-based taxes (such as the corporate tax or non-residential property taxes), from the redistributive activities of provincial governments and from the pricing policies and profits of Crown corporations.

Efficiency considerations dictate that these NFB differentials be eliminated (with the exception of those arising from differences in the cost of providing public services). Since the NFB differentials are the same as those that give rise to horizontal inequities, the remedy for fiscal inefficiencies is the same as that for horizontal inequities of the broad-based sort. As mentioned, the extent of the NFBs generated from source-based

taxes and from the redistributive activities of the provincial governments depends upon the workings of the price mechanism (particularly the shifting of taxes), upon the nature of provincial public services, and upon the net progressivity of provincial budgets. In the particular circumstances outlined in the ECC Report, fiscal efficiency, like fiscal equity, would call for the full equalization of all revenue sources. This corresponds to the case in which provinces provide equal per capita public services for their residents and levy residence-based taxes at proportional rates and whose source-based taxes are, on average, incident on foreigners. The same sort of provisos we outlined above for fiscal equity apply here also. Of course, if one opts for the narrow-based view of horizontal equity, there will be a conflict between the degree of equalization called for on efficiency grounds and that called for on equity grounds. The former will be greater.

This argument for equalization based upon fiscal efficiency is designed to correct only for labour market distortions arising from NFB differences. There are two caveats which ought to be borne in mind, both involving second-best considerations.

First, capital markets will misallocate capital across provinces if provinces levy different tax rates on capital income. Given this misallocation, the efficiency case for full equalization may no longer be valid given the usual second-best arguments. It is not apparent in which direction full equalization will err. The possibility of misallocation of capital is a good reason for harmonizing both tax bases and tax rates across provinces.

Second, there are other federal policies that induce labour misallocation or that have equalizing components. In principle, the ideal equalization scheme should take these into account. They include tariff policy, regional policy, oil-pricing policy and transport policy. Once again, it is not obvious what direction these other effects take on balance.

So far, all of the arguments for federal-provincial grants call for unconditional grants. The final class of arguments to which we now turn would justify conditional grants designed explicitly to give the provinces an incentive to undertake or expand certain types of expenditures.

Interprovincial Spillovers

The final argument for federal-provincial grants arises from the fact that actions taken by one province may confer external benefits on the residents of other provinces — interprovincial spillovers. It is useful to think of these spillover benefits as falling into two categories. The first is conventionally referred to as interjurisdictional externalities and results when public expenditures undertaken by one province yield direct benefits to the residents of another province for which there would ordinarily

be no compensation received in a decentralized system of decision making. The second category of spillover benefits might be referred to as the "gains from trade" from coordinating provincial expenditure programs in order to ensure that the full benefits of an internal common market are realized. Let us consider each of these in turn.

Interprovincial Externalities

Interprovincial externalities are analogous to externalities between households or firms. A decision maker, in this case a provincial government, undertakes an expenditure which yields benefits both to its own residents and to the residents of other provinces. The externality could, of course, be reciprocal. The total or social benefits of the activity in question consist of the benefits to a province's own citizens and the benefits to citizens of other provinces. Benefits to a province's own residents are referred to as private benefits, and those to other provinces' residents are external benefits. The presumption is that both sorts of benefits rise as the level of activity rises. A rational provincial government acting on behalf of its own voters would undertake that level of expenditures such that the marginal cost to itself from the activity equalled the marginal benefit to its own citizens — to whose benefits alone it must cater. There is no incentive to take account of the external benefits accruing to citizens of other provinces. All provinces are liable to be faced with similar circumstances. The end result would normally be too low a level of expenditure from a social point of view. Examples of this phenomenon might include education and manpower training programs (which are accessible to residents or potential non-residents), and highways, which are also used by non-residents.

One theoretical remedy is straightforward. It is to subsidize each provincial government to undertake the socially efficient level of expenditures.[9] The appropriate form of subsidy would be a conditional grant with a matching rate corresponding to the proportion of the benefits of the expenditures which spill over to the residents of other provinces. This is the remedy analogous to the Pigovian subsidy in the context of interpersonal or interfirm externalities.

This remedy, however, is virtually impossible to implement. As with any externality, the external benefits are difficult to measure: they do not correspond to any price that can be observed on markets. Furthermore, unlike externalities among households or firms, even the private benefits are hard to measure. It is also difficult to know how closely provincial government behaviour corresponds to ideal behaviour. Unlike households or firms, one cannot presume that public expenditures are chosen in such a way that marginal benefits equal marginal costs. Therefore it is difficult, if not impossible, to know what the appropriate matching rate should be. In practice, it will be chosen in a more or less arbitrary fashion.

Common Market Issues

It is often argued that tax harmonization is important in the presence of mobile factors and goods; so also is coordination on the expenditure side — including expenditures both on goods and services and on transfers. The free flow of goods and services in a federation will be enhanced to the extent that expenditure programs are uniform across jurisdictions. The strength of this argument depends upon how closely one would wish the federation to mimic a unitary state in terms of the expenditure programs undertaken. There may be good reasons for not interfering with the decentralized decision making of lower levels of government despite the impediments they may impose on the free flow of goods and factors of production. An important class of reasons concerns the fact that there may be systematically different preferences for various types of public services on the part of persons living in different provinces. The conflict between the desire for unimpeded mobility of goods and factors and the desire for decentralized decision making to respond to taste differences is one that must be resolved ultimately by the political process.

There are several areas of provincial jurisdiction where it might be desirable to have some mechanism for enforcing uniformity on programs in provincial jurisdictions. Those that affect labour mobility might include medical and hospital insurance, pensions, welfare, education or manpower training. There are other areas that might primarily affect capital mobility, such as industrial infrastructure, resource and agricultural development and transportation. Since these areas are normally within provincial jurisdiction, the federal government cannot directly ensure their uniform provision across provinces. Instead, it can influence them indirectly by the use of conditional grants; that is, by the use of the so-called spending power. In this case, there is no obvious reason why any particular matching formula should be appropriate, provided the grant were conditional. The size of the grant could be completely unrelated to what a recipient government decides to spend. The object is not necessarily to induce the provinces to expand their expenditures as in the case of externalities, but only to ensure that their expenditures correspond to a given degree of uniformity as stipulated by the conditions of the grant.

Since the purpose of these grants is to allow the federation to exploit collectively certain gains from an internal common market — gains which might otherwise be dissipated under decentralized decision making — one would expect that agreement could be secured among the provinces and the federal government in the first place. Indeed, this should be true whenever the spending power is used for any reason (including that of correcting for externalities). It might be argued that this is a test which the use of the spending power should always be required to pass; both the federal and provincial governments should agree to it.

There is another circumstance in which the federal government may use the spending power to ensure uniformity, and that is when the program under consideration falls jointly under the jurisdiction of the federal and provincial governments. The provision of welfare might be a case in point. Its purpose is partly to provide social welfare, which is a provincial responsibility, and partly to redistribute income, which can also be construed as a federal responsibility. Similarly, agricultural policies might involve this sort of split jurisdiction. The case for the use of unilateral spending power in these circumstances may be somewhat stronger.

Existing System of Federal-Provincial Transfers: The Problems

The evaluation of the existing system of transfers implies some view about the ideal system. As was stressed in the previous section, the ideal system depends upon one's interpretation of constitutional issues, one's value judgment about the appropriate notion of equity and one's judgment concerning certain key stylized facts about the workings of the economy (the incidence of source-based taxes, the mobility of factors, etc.). Having said this, let us for the sake of presentation adopt what the ECC Report regards as a reasonable constitutional/ethnic/empirical position — characterized as follows.

Constitutional Provincial decision making ought not to be interfered with in areas of clear provincial jurisdiction except with provincial consent. These latter cases include those in which national gains from trade can be had from correcting interprovincial spillovers and from coordinating taxes or expenditures. Otherwise, provinces ought to be free to determine their own budgetary policies, including their redistributive activities.

Ethical The broad-based view of horizontal equity should prevail except in the case of resource rents. In this case, property rights have been explicitly granted to the provinces by the *Constitution Act, 1867*, so the narrow-based view is proper.

Empirical The economy is essentially a small, open economy. Provincial source-based taxes are on average incident on foreigners. Those which are incident on residents are offset by those which are incident on the residents of other provinces (see note 7). Residence-based taxes are roughly proportional and provincial expenditures provide quasi-private goods of roughly equal per capita value to residents of the province.

Under these circumstances, the broad outlines of an ideal system of federal-provincial transfers can be sketched. Much hinges on the equal-

ization scheme, since the transfers of tax points and tax room are equalized. The ideal equalization scheme would be a net scheme which equalizes fully the tax capacity of all taxes except resource revenues. On equity grounds, a proportion of the latter should be equalized, given by the average federal tax rate (say, 30 percent), since these revenues represent a source of real income to provincial residents that would otherwise escape federal taxation. The equalization should be on tax capacity and should be calculated at national-average tax rates applied to provincial tax bases. All provincial and local tax revenues should be included as well as Crown corporation profits and hydro rents, whether dissipated by low prices or not. In measuring tax capacity, particular attention should be placed on resource revenues since, for them, the tax bases used by provinces may not correspond to tax capacity. It would be more appropriate to use resource rents as a reflection of tax capacity. In fact, it would be much more appropriate for provinces themselves to use rents as their tax bases rather than production or revenues, as at present, but this is something for the provinces to decide.

The existence of a set of Tax Collection Agreements much like the present one seems appropriate, with the division of tax room between the federal and provincial governments subject to negotiation. The choice of tax bases for personal and corporate taxes should also be subject to negotiated agreement, as should amendments to these bases. In principle, provinces could have rate structures separate from the federal government and be allowed to set their own rate levels as a proportion of the tax base. This would increase slightly compliance costs by taxpayers compared with the present system, but it would avoid the problem of provincial revenues changing when the federal government changes the tax base, as under the present system.

Other federal-provincial transfers not undertaken for reasons of interprovincial spillovers should be equal per capita across provinces. The exact magnitude of these depends upon the amount of tax room left to the provinces by the Tax Collection Agreements. The two methods of getting revenues to the provinces are equivalent, since equalized tax room approximately equals per capita grants under an ideal equalization scheme. Only the accountability for raising taxes will differ. The magnitude of per capita transfers should depend upon the aggregate revenue needs of the provinces compared with the revenue already provided from their own sources. The conditional nature of any of these transfers, if desired to coordinate provincial spending programs, should be subject to federal-provincial agreement. Such agreement should always be possible if there are gains to be exploited. Matching conditional grants are appropriate in cases in which spillovers among provinces exist. Here again, agreement should be possible between the federal government and the provinces before the spending power is used in this way.

These broad prescriptions concern the structure of federal-provincial

transfers rather than their exact magnitude. The latter will always be a matter of political judgment. The structure is, of course, contingent on acceptance of the principles outlined above. There may be good reasons for advocating a different structure on grounds of disagreement with these principles. Our objective in the following section will be to judge the main components of the existing federal-provincial grants against these norms. We begin with equalization since, as mentioned, its structure has implications for some of the other schemes. We will then consider, in turn, the Tax Collection Agreements, Established Programs Financing, and the Canada Assistance Plan.

Equalization

The Breau task force took as the objective of equalization the guarantee that all provincial governments have the fiscal capacity to ensure comparable levels of public services at comparable levels of taxation. This is a somewhat stronger statement than that found in the Rowell-Sirois Report, which was concerned only that minimum standards of services be provided at reasonable tax rates. The investigations of the ECC into the underlying economic rationale for equalization gave credibility to the Breau task force notion. Essentially, the ECC argued that, on grounds both of equity and efficiency, the full equalization of tax capacities was justified. The arguments were enumerated in the preceding section of this paper. The only stricture on pursuing this objective is a constitutional one concerning the provincial property rights to resources. In view of this, and despite efficiency arguments to the contrary, the ECC felt constrained to take a narrow-based view of horizontal equity with respect to resource revenues, and to advocate equalizing only a proportion of them. Let us use the ECC ideal as a benchmark against which to compare the existing system.

There are several ways in which the existing system and its immediate predecessor differ from this ideal. We shall deal with these differences point by point. There are also some alternative proposals that we might judge against the ECC version. These also will be dealt with in the points below.

Net versus Gross Schemes

The ideal system of equalization is self-financing; positive payments to "have-not" provinces would be offset by negative payments from "have" provinces. There would be no net contribution by the federal government. This is referred to as a net scheme. Under a representative tax system (RTS) approach to equalization — the type used in Canada — a net scheme would be mechanically easy to apply. It would, however, require that payments into the scheme be made by provinces

with tax capacities above the national average. Canadian equalization has always been on a gross basis. Equalization is paid to the have-not provinces out of revenues raised by the federal government. It is highly unlikely that these revenues would be incident across provinces in a manner anything like that which a net scheme would produce. Therefore, a gross scheme could not be fully efficient or equitable when judged by ideal standards. If one adopted the ECC view of the ideal equalization scheme, a gross scheme would be ideal only if the federal government collected all tax revenues on behalf of the provinces and distributed them to the provinces on an equal per capita basis rather than according to the principle of derivation. Of course, this happens to a certain extent now. EPF transfers are effectively equal per capita transfers from the federal government to the provinces. To that extent, EPF transfers contribute to the aims of equalization.

The Breau Report outlines some strong reasons as to why a net scheme would not be politically acceptable. It argues that the federal government has a responsibility for correcting regional disparities and that equalization could be viewed as an appropriate instrument. In addition, the Constitution explicitly makes the federal government responsible for making equalization payments. Of course, these arguments may not be compelling since there is nothing in the Constitution preventing the federal government from extracting negative equalization from the have provinces. However, from a practical point of view, there is no reason why the have provinces should agree to such payments, except, perhaps, as insurance against becoming have-not provinces themselves. (As an alternative, the federal government could impose differential federal income tax rates by province.)

It should be realized that there is an element of net equalization in the present scheme. One could view the revenue-sharing agreements between resource-producing provinces and the federal government as a way of obtaining equalization revenues from the have provinces to finance equalization payments to the have-not provinces. The energy agreement signed with Alberta gave the federal government a share of oil and gas revenues very close to what would be required to finance the equalization owing to the have-not provinces using the narrow-based view of horizontal equity.[10] In addition, the spreading of rents across the nation by artificially low energy prices represents a way, albeit arbitrary and inefficient, of equalizing resource revenues on a net basis.

In the end, it is probably unrealistic to imagine a full net scheme coming into operation. Perhaps the best that can be hoped for is that the gross scheme does all that it is capable of doing: bringing have-not provinces up to the national average. To the extent that this is supplemented by pseudo-equalization arrangements such as revenue sharing and EPF transfers, all the better.

Equalization in the Existing System

The ideal equalization scheme would equalize tax capacities to the national average. Up to 1982, equalization was based on a representative national average standard (RNAS).[11] Under this scheme, provinces obtaining less than the national-average per capita tax revenues by applying national-average tax rates of a representative set of taxes to their bases would receive enough equalization to bring them up to the average. If such a scheme were applied comprehensively to all revenue sources, it would correspond to the ideal.

The RNAS was abandoned in 1982 in favour of the representative five-province standard (RFPS). Under this system, all provinces are provided with enough equalization to raise their tax capacity up to the average of Ontario, Quebec, Manitoba, Saskatchewan and British Columbia. In effect, the resource-rich province of Alberta is omitted, as are the four Atlantic provinces, traditionally the least well-off. Unless the average per capita tax revenues raised at national average tax rates under the RFPS happened fortuitously to equal those under the RNAS, the RFPS would not be ideal. Instead, it would represent an arbitrary deviation from the ideal.

There are several adverse consequences of the RFPS, at least as judged by economic criteria. We shall list these below. The first two listed would not be viewed as adverse by the policy makers since they represent, not an unintended consequence of the RFPS, but the very rationale for adopting it. Nonetheless, from the standpoint of an ideal equalization system, they are aberrations. The consequence is a system that effectively amputates a good part of the economic purpose of equalization.

Oil and Gas Revenues

Since Alberta is not one of the five provinces in the standard, the average tax base to which national-average tax rates are applied in the case of oil and gas is negligible compared with that under RNAS. Consequently, Alberta's tax capacity in oil and gas (and other resources) is not equalized. This, of course, was one of the aims of the RFPS — to eliminate the cost to the federal government of equalizing oil and gas revenues. The argument used by the federal government was that it was unrealistically expensive to equalize these revenues, presumably because the federal government did not have direct access to them. In order to avoid the arbitrary measures that had been taken in the past to reduce resource equalization (such as including only one-half of resource revenues in the formula, capping them, and excluding the scale of Crown leases), a formula was devised which ostensibly treated oil and gas revenues on an equal footing with all other revenue sources but effectively eliminated them from the scheme by leaving Alberta out of the national average.

The difficulty with this argument is that the justification for avoiding oil and gas equalization based on a federal revenue constraint is invalid. As mentioned, the energy agreement reached between the federal and Alberta governments, in fact, gave the federal government access to resource revenues in roughly sufficient quantities to finance oil and gas equalization according to the narrow-based view. Thus, the argument that the federal government had no access to resource revenues to finance equalization could not be used to justify eliminating equalization from the scheme. In addition, there is nothing to prevent the federal government from using its corporate income taxing power to obtain a larger share of the resource rents. Indeed, this would be a particularly efficient way to do so.

Ontario Denied Equalization

Under the RNAS, Ontario would have been designated a have-not province by 1977–78. However, it has never collected any equalization. For one thing, the Ontario government has never appeared to desire any equalization, at least in the amounts owing to it at that time. For another, the introduction of the personal income override, by which any province with per capita personal income above the national average could not receive equalization, effectively excluded Ontario from equalization under the RNAS. This was viewed as an unsatisfactory solution, since it appeared to some observers (including the Breau task force) to be an arbitrary measure designed specifically to exclude Ontario. It seemed to be desirable to establish a set of general rules rather than arbitrary measures. The first general rule attempted was to switch from the RNAS to an Ontario standard by which the Ontario tax base would be used as a benchmark for equalization. Obviously this would have excluded Ontario. In the process, however, it had a number of other undesirable consequences that led to its undoing.[12] The replacement by the RFPS appeared to be less arbitrary, avoided some of the adverse incentive difficulties of the Ontario standard, but still had the effect of turning Ontario into a have rather than a have-not province as under the RNAS. Since the RFPS is itself arbitrary, this seems a no less arbitrary way of excluding Ontario than any other.

Have-not Provinces' Resource Revenues

By eliminating Alberta from the average tax base, the five-province per capita average resource tax base is very low relative to the national-average. The oil and gas revenues of Alberta do not get equalized. However, oil and gas revenues of the have-not provinces (e.g., Newfoundland and Nova Scotia) would reduce, comparably, the equalization entitlements of these provinces. This is because these revenues enter the formula as a component of the provinces' per capita tax base and are

subject to equalization at the national-average tax rate. Thus, equalization owing to the have-not provinces falls by the national-average tax rate applied to the provinces' tax base. Indeed, as we shall argue below, additional resource revenues of the have-not provinces may well be equalized at more than 100 percent. If their tax rates are below the national average, they will lose more in equalization than they will gain in resource revenues.

In any case, it is anomalous on equity grounds that the have-not provinces should be fully equalized on their own natural resource revenues, but should not have any equalization owing on account of the massive resource revenues of Alberta. It is also inefficient since it imposes a strong disincentive for provinces like Newfoundland to exploit their own natural resources.

Tax Bases Inadequate for Resources

Under both the RFPS and the RNAS, as well as under most other proposed schemes, tax capacities are approximated by actual tax bases. That is, what are equalized are the revenues that would be obtained by applying the national-average tax rates to the differences between the national average per capita tax base (or the five-province per capita tax base) and the tax base per capita in each province. In the case of most taxes this is a reasonable procedure to follow. However, in the case of resources, it can lead to two anomalies.

First, resource tax bases themselves are not exogenously given to the provinces. Provinces can influence the rate at which resources are discovered and developed and, thus, can influence the tax base itself. Since increments in the tax base reduce equalization entitlements directly, the equalization formula can impose a significant disincentive to develop resources, depending on the proportion of resources equalized. With resources entering fully into the RFPS formula, the disincentive can be significant. Even under the RNAS the disincentive could be significant. If a have-not province levied the average tax rate, and if it had an insignificant impact on the national average tax base, then equalization could impose a 100 percent tax on provincial resource revenues if the latter entered fully into the formula, or a 50 percent tax if only half of them entered.

Second, the tax base used for resource revenues is not a suitable indicator of the revenue-raising potential of the resource. Much of resource revenues are production royalties that are levied either on the quantity of output produced or on its value. However, the revenue-raising potential may be more closely reflected in the rents of the resource. Provinces whose resources can be recovered at lower cost can levy higher royalties than provinces having high-cost sources -- given

that both must end up selling at the same competitive price. Furthermore, marginal discoveries presumably cost more than inframarginal discoveries. The consequences of this are as follows. If, for example, Newfoundland acquires oil deposits in the Hibernia, which is relatively high cost, the revenue produced will appear in the equalization formula as an increment to Newfoundland's base and will be equalized at national-average tax rates. If the national-average tax rate exceeds Newfoundland's royalty rate, the equalization entitlement will fall by more than the extra resource revenue generated by the royalties.[13] In effect, Newfoundland will be taxed at a rate greater than 100 percent by an equalization formula which equalizes 100 percent of resource revenues as under the RFPS. Newfoundland could do very little about this excess tax rate except not to exploit the resource because the high cost of extracting the resource precluded the province from raising royalty rates to the national average.

This latter difficulty will be partly avoided under the ECC scheme, since much less than 100 percent of resource revenues would be equalized. Nonetheless, some disincentive to development still exists. The difficulty is that actual tax bases are not a reliable indicator of tax capacity in the case of resource rents. The tax capacity is probably better measured by the potential rents of resource properties in the province. The problem could be partly avoided if provinces used rents (or income) as a tax base for resources rather than revenues or output. In fact, this would solve the second problem. However, to solve the first problem involves using potential rather than actual rents as a tax base. Obviously, this would be difficult to administer.

Equalization of Resources Revenues

The proportion of resource revenues one wishes to equalize depends upon one's view of equity and on the trade-off between equity and efficiency. The ECC leaned on constitutional arguments to suggest that only a proportion of resource revenues should be equalized, the proportion being given by the federal tax rate. The pre-1982 RNAS did equalize only a part of resource revenues; however, that part was determined in a relatively arbitrary manner. The RFPS system now in effect purports to equalize at 100 percent but, of course, it omits from the standard tax base all resources found in Alberta and the Atlantic provinces. The ECC view would seem to be the preferable approach because it is based on national average standards, because it is based on a reasonable view of equity and because it avoids some of the disencentives of the RFPS system.

An alternative proposal, and one not too different from that of the ECC, is that of the Breau Report,[14] which argued that the proportion equalized should be given by provincial income tax rates. The argument was based

on the view that, if the resources had been privately owned, this is the amount of provincial revenues that would have been collected in taxes and would have entered the equalization formula. In fact, resources are not privatized so the "as if" situation is purely hypothetical. There is no particular reason why equalization should be based on a set of circumstances that do not in fact exist.

Ceiling on Equalization in Existing System

Under the existing system, equalization payments are precluded from growing more rapidly than the growth in nominal GNP. This cap is imposed essentially to prevent costs to the federal government from escalating. There is no economic reason for this ceiling; its imposition is essentially arbitrary. If the federal government wishes to reduce aggregate transfers to the provinces, or implicitly to increase its own tax room, it should do so by EFP transfers or tax room directly rather than by cutting back equalization whose magnitude is based on other considerations.

Inclusion of Provincial Government Savings

Both the Breau Report and the ECC Report argued that provincial revenues that were saved rather than spent should be exempted from equalization. The prime example of this is the Alberta Heritage Fund. They argued that only interest earned and spent or the drawing down of the fund ought to be equalized. The rationale for this suggested treatment of provincial savings is that, since they are not used to finance current provincial services, they do not contribute to differences in the ability of provinces to provide services at comparable tax rates. Theoretically such a view is correct. However, the administrative implications could be considerable. Provincial budgets must be monitored to determine what proportion of revenues are spent and what are saved. To be fully consistent, provinces that run a surplus would have their equalization reduced, while those that have deficits would have equalization increased. This would introduce an element of uncertainty into the system.

Fortunately, from a present-value point of view, the amount of savings accumulated in a heritage fund is equivalent to future interest and decumulations. Thus, it should not matter (except for timing) whether equalization is based on tax receipts on a cash-flow basis, or whether it is restricted to those that are actually spent. It would be simpler to equalize all revenue sources (except for interest) regardless of whether they are devoted to current or future expenditures on public services.

Discrimination against Low Income Provinces

The Breau Report pointed out a way in which the existing equalization system may work to the disadvantage of low-income provinces. In equalizing the personal income tax, only tax revenues actually collected are included in the formula. There are varying numbers of taxpayers across provinces who would be in a non-taxpaying position, or who might reasonably be regarded as potentially negative taxpayers. The provinces may be making income transfers to them in the form of welfare assistance and tax credits. The equalization system does not account for these persons.

From a theoretical point of view, this is a legitimate complaint. The argument for full equalization of residence-based taxes, like the income tax, rests on their being incident on taxpayers roughly in constant proportion to income. If the system is more progressive than that, more than full equalization is called for. The existence of a group of non-taxpaying persons or transfer recipients implies that the system is more progressive than a proportional tax. This would tend to lend weight to the desire for more rather than less equalization to low-income provinces.

Inclusion of Hydro-electric Rents

As pointed out in the previous section concerning the economic rationale for grants, one can regard the rents generated by provincially owned hydro-electric resources as an appropriate item for equalization. These rents can take the form either of profits of Crown utilities that currently go untaxed and thus are not equalized, or they can be dissipated as lower prices to resident consumers. As the ECC showed, the magnitude of these rents can be substantial. In principle, they should be equalized on the same basis as other resources. If we take the narrow-based view of horizontal equity, a proportion equal to the federal tax rate on residence-based taxes should be equalized.

Need and Cost Differences

The ability to provide national average levels of public services at national-average tax rates can depend critically on differences in cost per service and need per capita across provinces. On equity grounds one would like the equalization system to account for such differences. The U.S. revenue-sharing system and the Australian system of grants do so in crude ways. As well, some conditional grants do so. The difficulty here is not one of principle but of measurement. How to devise a comprehensive index of need or cost, covering all public services that could be used in an equalization formula is not obvious. Nor is it obvious, even qualitatively, which of the provinces would be expected to be favoured by the inclusion of need or cost factors.

Public Infrastructure

Not all public services are quasi-private goods provided to residents. Some are intermediate goods including capital infrastructure, while others are public goods. The ideal equalization system would take these into account. In the case of infrastructure, as we saw earlier, to the extent that these benefits ultimately accrue as factor incomes, they need not be equalized; if they ultimately benefit residents through lower output prices, they should be equalized. It is rather difficult to be certain as to exactly how the benefits of public spending are distributed. In addition, the full benefits from current infrastructure spending may not accrue until several years down the road. On balance, however, the fact that some spending is on intermediate goods would argue for less than full equalization.

In the case of pure public goods, one cannot be sure. Pure public goods yield economies of scale in consumption, so that the larger the population, the greater the benefit per tax dollar of public goods. How this could be implemented into an equalization scheme is not obvious.

Second-best Arguments

The system of equalization is not the only manner in which real income is redistributed across provinces. Many other federal policies impart provincial or regional biases. Subsidies to firms assist low-income provinces as does the unemployment insurance scheme. Tariffs are presumed to assist Central Canada. Transportation policy favours the Prairies and the Maritimes. Tax policy has ambiguous effects. Some taxes favour the manufacturing industries (e.g., the corporate tax); others do not (e.g., the manufacturer's sales tax). The same is true for resource industries. Other conditional grant programs may favour some provinces rather than others. Ideally, one would like to take all these into account in designing the ideal second-best equalization scheme. In practice, this is impossible, since no reliable estimates of the net impact of all federal programs by province are available. Nor is it obvious a priori which provinces are favoured and which are not. For example, the provinces themselves would not agree unanimously on who has gained and who has lost by existing policies. Thus, it is not clear how these second-best considerations can be taken into account.

Macro-Indicator Approaches

Some authors have argued that the equalization scheme could be simplified if it were based on an aggregate such as per capita income.[15] That is doubtless true. However, it is not obvious what would be gained from such a system. The amount accruing to each province would bear no

particular relation to that which would be called for on the grounds of either efficiency or horizontal equity as defined above.

Tax Collection Agreements

The Tax Collection Agreements fulfil several important functions in the economic union. First, they are the vehicle by which income taxes are harmonized among the governments that are party to them (i.e., all provinces except Quebec in the case of the personal income tax, and all provinces except Alberta, Ontario and Quebec for the corporation income tax). As such, they contribute to the unimpeded free flow of goods and services. Second, they establish a set of allocation rules for dividing provincial tax revenues according to their province of origin. Given the recent controversy over "unitary taxation" in the United States, the continuance of such a system, even though only a crude one, is important. Third, by having the federal government collect taxes for both itself and the provinces simultaneously, the administrative costs of tax collection are economized. For these reasons, most observers acknowledge that the Tax Collection Agreements are a valuable adjunct to the more explicit federal-provincial grants.

Nonetheless, in recent years there has been considerable concern about the operation of the agreements and especially about the friction that has developed between the federal and provincial governments. In this section, the most apparent of these concerns are discussed, and some suggestions for reform are presented. Much of the concern stems from the conflicts that naturally arise in a federal system from the benefits of a centralized, uniform system of taxation and the benefits of decentralized, discretionary decision making by the provinces. The ideal federal tax system would be that in which one obtains the benefits of centralization in the form of tax harmonization and low collection costs while at the same time accommodating the desires of the provinces to pursue their own tax policies and structures in accordance with the desires of their limited constituencies in a manner that does not unduly fragment the economic union. It is not obvious that such an ideal could ever be achieved. Uniformity ultimately conflicts with provincial autonomy. The appropriate compromise is a matter of political judgment.

In what follows we present and discuss briefly the major irritants in the existing system. Many of these have also been discussed in the recent Ontario Economic Council study entitled *A Separate Personal Income Tax for Ontario*, hereinafter referred to as the OEC Study.

Unilateral Actions by Federal Government

Under the present system, the personal income tax collected for the provinces is based on a provincially determined tax rate applied to basic

federal taxes payable. In the case of the corporate tax, the provinces select a tax rate to apply to taxable income. In both cases, actions by the federal government will affect both the amount of tax collected and its allocation among taxpayers. In the case of the personal income tax, the provinces must adhere both to the base and to the rate structure determined by the federal government. Unilateral changes in either of these by the federal government will affect both the revenues of the provinces and the degree of progressivity of their taxes. A negative revenue effect above a threshold is cushioned for one year by the revenue guarantee, but after that provincial countervailing action must be taken to restore tax revenues.

Three sorts of objections may be raised to this by the provinces. The first is that the federal government is able to change, unilaterally, the base of the personal income tax that is, after all, a tax field jointly occupied by the provinces. The second is that the provinces have no scope for altering the progressivity of their personal income taxes, except through the use of special credits, tax reductions and surcharges. The third is that the federal government can unilaterally affect the revenue-raising ability of the provinces, since provincial tax is determined as a proportion of federal tax. The latter two could be dealt with, at least partially, if the provinces were allowed to apply their own rate structures to a commonly agreed base. This idea, proposed by the OEC Study, would not introduce a great deal of complexity into the system and would provide the provinces with considerable discretion over the progressivity of their own taxes. In addition, it would be possible to dispense with the revenue guarantee since federal tax-rate changes would no longer cause changes in the taxes collected for provincial governments. The costs of this system would be the minimal additional collection costs plus some reduction in tax harmonization.

The unilateral federal choice of a tax base is more problematic. The desirability of a common tax base is strong; therefore, some centralized mechanism must be used to determine it and to introduce changes when needed. The issue is whether or not that authority ought to rest solely with the federal government. One possibility also suggested by the OEC would be to establish a federal-provincial tax structure committee which, at the very least, could perform a consultative role in determining the tax base. Whether it would have actual decision-making power over the tax base is another matter, given the reduction in federal budgetary flexibility this would imply.

The corresponding problems with the corporate tax are less severe, since the provinces already apply their tax rates directly to the common base rather than to federal taxes. They are, therefore, able to set their own rates and to vary them independently if they so desire. Nonetheless, they are obliged to use the same base as the federal government, and so the federal-provincial tax structure committee would presumably

also have a role in determining the tax base and changes to it. The ability of the provinces to set their own corporate tax rates is not without costs, since capital allocation is presumably highly responsive to corporate tax rates. Realistically, there is probably nothing that can be done about this.

Inability of Provinces to Introduce Special Measures

Another argument stressed by the OEC Study is that there is only limited flexibility allowed to provinces to introduce their own credits and subsidies. In fact, what the federal government has been willing to administer (for a fee) are credit/subsidy measures that are administratively simple, that will not erode the harmonization or uniformity of the tax system and that will not jeopardize the economic union. The federal government retains discretion as to what measures do or do not satisfy these criteria. Two points might be made here. The first is that the above-mentioned tax structure committee could be involved in determining which credits and subsidies are admissible and which are not. Second, as the OEC Study recommended, the tax credit system could allow the provinces more freedom to institute measures that do not discriminate against other provinces' residents or firms. They argued that it was folly not to allow this sort of thing since the provinces would, in any case, introduce them outside the personal or corporate tax systems in another form. Indeed, they might be induced to leave the Tax Collection Agreements if they were denied some measure of discretion.

The OEC also suggested that the provinces might well be asked to conform to some "code of economic conduct." The exact nature of this code was left rather vague, but the intent would be to ensure that provinces do not engage in measures that erode the economic union by discriminating against the residents of other provinces.

Not All Provinces Included in Agreements

One of the apparent barriers to complete income tax harmonization is the fact that not all provinces are party to the Tax Collection Agreements. Quebec administers its own personal income tax, and Alberta, Ontario and Quebec have their own corporate taxes. This is at least partly due to a dissatisfaction with the amount of discretionary power residing with the federal government in matters relating to the choice of tax base and the use of discriminatory provisions. These provinces have, nonetheless, abided by the base used by the federal government as well as by the allocation rules. They are, however, free to introduce provincially discriminatory measures, and this can be regarded as one of the real disadvantages of the provinces going their own ways. Examples of this include special incentives for provincial firms to invest in the prov-

ince or measures introduced enabling persons to put their savings into provincial securities, as with the Quebec Stock Purchase Plan. One of the advantages of reducing the ability of the federal government to make unilateral and unannounced changes would be that provinces might be less inclined to go it on their own. Even so, provinces may still prefer to withdraw because of the strictures on discrimination. For example, Alberta apparently withdrew from the corporate tax agreement in order to have the ability to use tax incentives to encourage local firms. The ability of provinces not adhering to the Tax Collection Agreements to introduce discriminatory measures against which others cannot retaliate is a difficult irritant for which there is no easy remedy. The best that can be done is to reduce the "price" of joining the Agreements.

Not All Taxes Included

The Tax Collection Agreements currently cover only the personal and corporate taxes, since these are the main tax bases actually co-occupied by both levels of government. Nonetheless, the provinces levy other sorts of important taxes, and some degree of harmonization would be desirable for them as well. There are two other main revenue sources in which uniformity is distinctly lacking: commodity taxes and resource taxes. In the case of commodity taxes, bases differ among provinces, as do rates. It is not obvious that an arrangement like the Tax Collection Agreements would be appropriate here, since there do not seem to be any special advantages to centralized collection. The bases are not co-occupied by the two governments. Nor is the degree of disharmony great enough to impede the free flow of goods and services significantly.

The case of resource taxation is a cause for greater concern. There exists a wide variety of provincial practices in taxing resources, both renewable and non-renewable.[16] Some provinces levy royalty-type taxes based either on quantity of output (per unit royalties) or on its value (ad valorem royalties). Others levy taxes on income or profits defined in various ways. Some provincial taxes on resources are flat rate; others are graduated. Some have taxes on the value of resource stocks held, and some have exploration and development incentives.

The effect of these different tax treatments is twofold. First, they cause a misallocation of investment and employment in resource industries among provinces. Second, the manner in which resource taxes are levied is highly distorting. Ideally what one wants is a tax on rents per se rather than taxes on output or revenues. A tax on rents is neutral, while a tax on output discourages production, in some cases quite substantially. It is now well-known from the public finance literature that rent taxes are feasible from an administrative point of view.[17] Furthermore, they could easily be collected with ordinary corporate tax revenues since they use basically the same information. This suggests that one useful extension

of the Tax Collection Agreements upon which the provinces might well agree is provincial resource taxes. Both the coordination of tax bases and the institution of an efficient system of resource taxes could be accomplished at the same time.

Federal Pre-emption of Tax Room

The provinces have the freedom to set the tax rates that they desire, given the rate of federal tax already in existence and given the magnitude of transfers from the federal government to the provinces. As we have argued, providing tax room to the provinces is, in a broad sense, an apt substitute for making federal-provincial transfers, given a sensible equalization system. It would seem reasonable that the overall means of getting tax revenue to the provinces, whether by tax room or outright transfers, ought to be the subject of negotiation. This is one of the matters on which an advisory body (such as the federal-provincial tax structure committee recommended by the OEC Study) could be consulted.

The basic point to emerge from our consideration of the Tax Collection Agreements is that they fulfil a very important function in the federation by harmonizing some of the tax bases. Most suggestions for reform have had to do with strengthening the Agreements by making them more palatable to the provinces. The most concrete proposals include: allowing the provinces to stipulate their own tax structures to be applied to the agreed tax base; allowing the provinces considerable leeway in establishing their own credits and subsidies provided they are non-discriminatory; enforcing tax harmonization by a code of economic conduct; introducing the requirement for more consultation before action is undertaken to change a tax base; and allowing consultation on the broader issue of the division of tax room on shared bases.

Established Programs Financing

The issues surrounding established programs financing (EPF) fall into four historical phases. It will be convenient to deal with them chronologically. The first phase was the pre-1977 period when the federal-provincial cost-sharing arrangements for medicare, hospital insurance and postsecondary education were in effect. This was followed by the first five-year period of EPF, 1977–82. Next came the EPF arrangements beginning in 1983. Finally, there is the *Canada Health Act*[18] that changes the terms of the existing EPF transfers.

Federal-Provincial Cost Sharing to 1977

Prior to 1977, medicare, hospital insurance and postsecondary education was financed jointly by the federal and provincial governments. This

was accomplished by a set of matching conditional grants of a particular sort. In the case of medicare, the federal government contributed to each province 50 percent of the per capita national average costs multiplied by the province's population. With hospital insurance the per capita transfer was made up of 25 percent of the national average costs plus 25 percent of the actual costs to the province to which the transfer was being made. Thus, in neither of these cases were the provinces spending 50-cent dollars at the margin. Provincial medicare expenditures were virtually unsubsidized at the margin (except to the extent that a province's expenditures raised the national average). Provincial hospital expenditures were subsidized at the rate of 25 percent. In the case of postsecondary education, provinces received an equal per capita grant prior to 1967. This was replaced by a system of tax abatements plus a cash transfer of the greater of 50 percent of operating expenditures or $15 per capita. The latter would rise thereafter at the national rate of growth of postsecondary education operating expenditures and could also be regarded as a conditional grant with a virtually zero marginal subsidy rate. The noteworthy characteristics of this system of cost sharing are that: the grants were conditional; the marginal subsidy was often very small; and the subsidy rose at roughly the rate of growth of total provincial government expenditures in these areas.

Three sorts of concerns with these cost-sharing arrangements led to their abandonment: induced inefficiencies, the mix of matching and per capita elements, and cost to the federal government.

Induced Inefficiencies

The provinces argued that the strings attached to the use of these funds was unduly restrictive, and they resented the detailed auditing requirements. For example, their use for such things as extended care, nursing homes and mental hospitals was not permitted. The consequence was the inefficient use of provincial health resources — especially for hospitals that were partly subsidized at the margin. In the case of extended care, more expensive acute-care facilities were provided in hospitals. More generally, there was an objection to the federal government's use of its spending power to influence the expenditure decisions of provinces in areas of provincial jurisdiction.

The Mix of Elements

The grants were largely equal per capita with, in the case of hospitals, some element of matching individual provincial expenditures. Depending on one's point of view, this may or may not be efficient. Matching grants are suitable as a remedy for spillovers from marginal provincial expenditures. One might argue that spillovers are a characteristic of postsecondary education, so some matching might be justified there. In the case of health, the argument for grants is probably more to establish

national standards, so subsidies of provincial government expenditures are probably not appropriate. However, whether one wants equal per capita grants is another matter. As the ECC Report pointed out, there exist wide differences in need and cost in health expenditures across provinces. For example, age structures differ considerably, as does access to hospitals and physicians' services. Equal per capita transfers (unlike matching grants) take no account of these differences.

Cost to the Federal Government

On the purely financial side, the federal government was committed to paying one-half of national average costs of these programs, despite having no direct control over the expenditures. It was therefore concerned about the escalating cost to it of the arrangements. Much of the argument was unjustifiably couched in terms of "50-cent dollars" as if, somehow, the escalating costs were due to the cost-sharing arrangements themselves. However, as we have argued, the existence of 50-cent dollars was a myth, and provinces that were treating health expenditures as such were not behaving rationally.

Established Programs Financing 1977–82

The institution of EPF in 1977 took steps to satisfy the main concerns of the cost-sharing arrangements. The grants were replaced by block conditional grants of roughly equal per capita size, half in the form of cash transfers and half in the form of equalized tax points. Significantly, the equivalent of two tax points was added to compensate the provinces for the elimination of the revenue guarantee which had been in existence since the tax reform of 1972. The overall rate of growth of EPF was set at the rate of growth of nominal GNP per capita.

These reforms affected both the efficient use of the funds and the financial commitments of both the federal and provincial governments. We shall consider each of these in turn.

Efficiency

The move from specific conditional grants to block grants gave the provinces much more leeway in organizing their spending priorities and, as a consequence, efficiency in the use of these funds is said to have increased. For example, extended-care services are now eligible for financing; consequently, extended-care services have been integrated with general hospitals. Whether this can be attributed solely to EPF is questionable since, as argued earlier, there was only a small subsizing component in the cost-sharing arrangements to begin with. The block grants were not without conditions, but the conditions were rather general. For example, in the case of health care provinces could qualify for EPF if their insurance plans were comprehensive, universal, portable, accessible and publicly administered.

Financing

The new formula had implications for the allocation of funds among provinces and for the allocation of funds between the federal and provincial governments. In the case of the former, the removal of any matching element from health transfers eliminated, along with subsidies, any element of need and cost from the system. In addition, the unnecessarily complicated use of tax points benefited the well-to-do provinces, since the equalization of these points applies only to the have-not provinces. The more important issue concerns the implications of the EPF for the sharing of tax room between the federal government and the provinces. The previous cost-sharing formula ensured that federal government transfers rose at the rate of expenditures on health care and postsecondary education. Under EPF, federal per capita grants would rise at the rate of growth of GNP. Since it is widely predicted that health care expenditures will continue to rise more rapidly than GNP,[19] this could be viewed as a unilateral shifting of financing ability or tax room away from the provinces.

Established Programs Financing Post-1982

Except for one provision, the second five-year set of EPF arrangements is basically the same as the first. The federal government has eliminated the equivalent of the tax points given in lieu of the revenue guarantee. Whether or not one views this as reneging on an earlier agreement, it does have the consequence of further shifting tax room away from the provinces to the federal government. This effect is strengthened by the federal government's application of the "6 and 5" anti-inflation guidelines to the increase of postsecondary education grants.

Canada Health Act 1984

The federal government has again initiated a unilateral change in the arrangements. The *Canada Health Act* penalizes provinces which allow their health systems to engage in extra billing or user costs. There is a one-dollar reduction in the EPF cash grant for every dollar collected in one of these two ways. The federal government argues that these violate the requirement of accessibility of health insurance. Where previously the only recourse to the federal government was to make the province ineligible for transfers, under the *Canada Health Act* the possibility of lesser and more credible penalties is introduced. This represents a reversal of the effects of the EPF program in that it imposes tighter conditions on health spending.[20] Though it will have no significant overall financial effects, it could have severe constitutional and efficiency effects. On the constitutional side, it represents a move in the direction of the federal government's using its spending power unilaterally to influence provincial spending on items purely within the

provincial jurisdiction. From the provinces' point of view, there is no compelling spillover argument to justify such a move. Indeed, the provinces would argue that the tightening of the purse strings in this way prevents them from responding to the growing pressures on the health care system by introducing, say, user costs, in an innovative way to increase the efficiency of the system.

These recent developments in EPF grants underline two of the main problems that have also come up in the context of equalization and the Tax Collection Agreements. The first of these problems is the strain that arises when the federal government takes unilateral actions that affect the ability of the provinces to make budgetary decisions within their own jurisdictions. The second problem is the overriding importance of achieving vertical balance within the federation; that is, ensuring that both levels of government have a proper share of access to the limited tax sources available. Here, too, the concern is the federal government's excessive exercise of unilateral power.

The Canada Assistance Plan

The Canada Assistance Plan (CAP) is the sole remaining sizeable federal-provincial shared-cost program. The grants from the federal government are 50 percent matching conditional grants based on provincial expenditures on needy persons in two areas — social assistance and social services. Social assistance refers to transfer payments made to the needy in the form of provincially or locally administered welfare assistance. Social services to needy persons include rehabilitation services, counselling and referral services, child welfare services, daycare services, homemaker and home support services, information services, community development services, research, consultation and evaluation, and administrative services. In the case of social services, the costs eligible for the 50 percent grant are operating costs in excess of the costs of providing the services in the base year 1964–65. Thus, at the margin, the subsidy is virtually 50 percent of operating costs.

A bill was introduced in Parliament in 1978 that would have supplanted the matching grant to social services by a block non-matching conditional grant while retaining the social assistance transfer on a 50 percent matching basis. Initially, the size of the grant would have been equal to the per capita national average federal contribution for social services in 1977–78 multiplied by provincial population. It would have risen at the rate of growth of nominal GNP, thus making it similar to the EPF scheme. The bill was never enacted but, obviously, the option of moving to a block grant remains.

The existing system of matching grants gives the provinces considerable leeway in setting their own rates for social assistance and establishing their own set of social services. The major strings attached to the funds are that, to be eligible for aid, individuals must be needy, and there

can be no residence requirements. The main constraint this imposes on the provinces, as discussed in the Breau Report, is that the restriction to the needy has precluded the provinces from using the funds to assist the working poor. If the programs could be income-tested rather than needs-tested, assistance to the working poor would be possible. Other than this, there have been relatively few complaints from the provinces about CAP. Of course, the federal government may be as concerned with escalating costs in this shared-cost program as it was with the previous cost-sharing arrangement for health care. That was, presumably, one of the rationales for the bill of 1978.

In discussing CAP, it is useful to consider the rationale for the two categories of expenditures separately.

Social Assistance

Basically, social assistance or welfare payments are made for redistributive reasons to transfer income to the needy. The Breau Report argued that this implied that social assistance was a matter of co-jurisdiction between the federal government and the provinces and that this justified a federal presence in welfare assistance. Whether a matching scheme is the most appropriate way for the federal government to participate is another matter. That is contingent on there being inter-jurisdictional spillovers arising from welfare payments. There is a body of economic literature on the spill-over effects of local government income redistribution that would support the supposition of spillovers.[21] The argument is that local governments provide welfare assistance because of the altruistic feelings of local residents toward the low-income persons in their jurisdictions. However, local governments are discouraged from being too generous for fear of attracting low-income persons from other jurisdictions. Therefore, the decentralized provision of welfare would result in too low a level.

Whether or not such spillovers exist and how large they might be are empirical questions, but they are particularly difficult to verify. It depends both on the mobility of low-income groups and on the fact that the altruism of local taxpayers is directed at the low-income persons in their own area but not to those in others. Nonetheless, a case can be made for there being some spillovers here and for having matching grants of the sort in existence.

An alternative way to proceed would be to have block funding of the type used in the EPF system. One of the difficulties with block funding is that, if it is done on a per capita basis, any element of cost or need differences is eliminated. We have already pointed out, in the section concerning the economic rationale for grants, that need or cost differences can be justified on equalization grounds. On the other hand, block funding does remove the incentive effect of matching grants that induce

provinces to spend more in these areas. If it were judged that spillovers did not exist, one could try to design a block grant system that incorporated need and cost elements rather than being equal per capita across provinces. It would be difficult to do this without, at the same time, providing provinces with an incentive to spend more.

If block funding were instituted, one would also have to stipulate its rate of growth. It could be at the rate of growth of GNP as with EPF, or it could be at the rate of growth of aggregate provincial government expenditures in this area. The latter would have the advantage of leaving the relative financial capacities of the federal government and the provinces as they are under the present system.

After having considered the alternatives, the Breau Report came to the conclusion that the present system ought to be retained rather than moving to block funding or the provision of tax room to the provinces. Their argument was based primarily on the argument of co-jurisdiction, although, as we have suggested, this in itself does not justify matching grants. The ECC Report did not consider CAP at all.

Social Services

The provision of social services is more clearly in the area of provincial jurisdiction than is social assistance. Nonetheless, the same arguments for matching grants on the basis of spillovers can presumably be applied here as in the latter case. However, for constitutional reasons, one may prefer to require provincial government agreement for the use of the spending power in this area. According to the evidence presented by the Breau Report, this agreement may not be difficult to obtain. There is also some evidence that the provinces appreciate federal initiatives in social services, perhaps because of the existence of federal expertise in the area.

The Breau Report argued for a system of block funding similar to the system proposed in the bill of 1978. This would provide the provinces with more flexibility in the use of funds and would remove the heavy-handed use of the federal spending power in an area of clear provincial jurisdiction. Presumably, it would also contain the growth of the federal contribution. The report did, however, recognize that this was unlikely to be politically feasible; it therefore suggested, as an interim measure, that the restrictions on the eligibility of social-service spending be loosened up to give the provinces more flexibility. They were not explicit as to what exactly should be the looser eligibility criteria.

The Breau Report also argued that the cost-sharing formula recognize differences in need across provinces. Such differences are already recognized to the extent that they are reflected in higher provincial spending in some provinces than in others. We have discussed the appropriateness of including need in the equalization formula. To include it separately in

CAP would be a piecemeal approach. It would give weight to need differences in the provision of one sort of service (social services) but would ignore the fact that there are likely to be need differences in other services as well.

Concluding Remarks

In this paper, we have restricted our attention to the four major methods used by the federal government to transfer funds to the provinces: equalization, Tax Collection Agreements, Established Programs Financing, and the Canada Assistance Plan. We have summarized the economic rationale for various sorts of transfers and have evaluated these schemes from the purely economic point of view.

What is apparent from our discussion is not so much the defects of the present system of grants but how well-served the Canadian federation is by it. Compared to, for instance, grants from the U.S. federal government to the states, our system seems particularly equitable and efficient. There are, however, some ways in which matters could be improved. The equalization system should revert to a national-average approach as existed before 1982, and its coverage should be broadened to all revenue sources. The Tax Collection Agreements could benefit from a more cooperative approach between the two levels of government. There should be less of a tendency for the federal government to take unilateral decisions on matters affecting the structure of various grants, particularly on matters affecting the relative access of the two levels of government to tax revenue sources. There should be more account taken of the effect on vertical balance of the various changes recently instituted by the federal government and on the interrelationships among the various grant types. By and large, federal-provincial transfers are in good shape, and they provide a sound base from which improvements can be made.

Notes

This paper was completed in September 1984.

I am grateful for the assistance provided by Chiichii Ashwe in the preparation of this paper and, for comments on an earlier version, to John Sargent, Douglas Clark, Frank Gregg, James Lynn, Robert McLarty and members of the Research Advisory Group on Federalism and the Economic Union. Two anonymous referees also provided very helpful comments, although at least one of them will undoubtedly still take issue with the normative perspective adopted in the paper.

1. See, for example, Oates (1972), Musgrave and Musgrave (1976), Boadway (1980), Atkinson and Stiglitz (1980), Boadway and Flatters (1982a), and Boadway and Wildasin (1984).
2. The notion of tax competition is discussed and analyzed in Break (1967, 1974), Boskin (1973), Breton and Scott (1978), and Starrett (1980).
3. See, for example, Boadway (1982).

4. Economists are more and more using expenditures rather than comprehensive income as the index of individual well-being. See Meade et al. (1978) and United States Treasury (1977). The arguments of this paper can be readily adapted to this convention.
5. The identification of this source of inequity is usually attributed to Buchanan (1950). It was adapted to the Canadian context by Graham (1964).
6. For a discussion of the problems arising out of the Heritage Fund, see the special issue of *Canadian Public Policy* devoted to it, vol. 6, Supplement (February 1980).
7. If source-based taxes of a province are exported to other provinces in the same amount as that borne by the province's own residents, full equalization is still desired. For a full discussion of this see Boadway and Flatters (1982a).
8. Again, the early analysis of this issue was due to Buchanan (1952). See also Scott (1952), Tiebout (1956), Buchanan and Wagner (1970), Buchanan and Goetz (1972), Flatters, Henderson, and Mieszkowski (1974), and Stiglitz (1977). For a survey of the technical literature, see Boadway and Flatters (1982b).
9. Another theoretical remedy would be for the provinces to compensate one another for the spillovers by a system of interprovincial payments. In the absence of such a system of voluntary payments (bribes), a central system of subsidies as outlined in the text would be required.
10. This argument is made in Boadway, Flatters, and LeBlanc (1983).
11. This terminology and that of the RFPS below is borrowed from Courchene (1983).
12. These are discussed in Courchene (1983).
13. This example should be taken as illustrative only. In fact, a separate category of resource revenues will be created for off-shore oil, and the tax rate used for equalization will be different from that of on-shore. Nonetheless, the general point applies that higher cost deposits within any category will have lower tax capacity than lower cost deposits.
14. This, in turn, was originally suggested by Gainer and Powrie (1975) and by Powrie (1981).
15. See, for example, Davenport (1979).
16. For a discussion of resource taxation see Cairns (1982).
17. See the discussion in Boadway, Bruce, and Mintz (1982).
18. S.C. 1983–84, c. 6.
19. See the discussion in Watson (1984).
20. For a fuller discussion of the implications of the *Canada Health Act*, see Watson (1984).
21. See Breton and Scott (1978) and Pauly (1973).

Bibliography

Atkinson, A.B., and J.E. Stiglitz. 1980. *Lectures in Public Economics*. Maidenhead, U.K.: McGraw-Hill.

Boadway, R.W. 1980. *Intergovernmental Transfers in Canada*. Toronto: Canadian Tax Foundation.

_____. 1982. "A Note on the Method of Taxation and the Provision of Local Public Goods." *American Economic Review* 72: 846–52.

Boadway, R.W., and N. Bruce. 1985. "Theoretical Issues in Tax Reform." In *Approaches to Economic Well-Being*, volume 26 of the research studies prepared for the Royal Commission on the Economic Union and Development Prospects for Canada. Toronto: University of Toronto Press.

Boadway, R.W., N. Bruce, and J. Mintz. 1982. "Corporate Taxation in Canada: Towards an Efficient System." In *Tax Policy Options in the 1980s*, edited by W.R. Thirsk and J. Whalley, pp. 171–216. Toronto: Canadian Tax Foundation.

Boadway, R.W., and F.R. Flatters. 1982a. *Equalization in a Federal State: An Economic Analysis*. Study prepared for the Economic Council of Canada. Ottawa: Minister of Supply and Services Canada.

_____. 1982b. "Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results." *Canadian Journal of Economics* 15: 613–33.

Boadway, R.W., F.R. Flatters, and A. LeBlanc. 1983. "Revenue Sharing and the Equalization of Natural Resource Revenues." *Canadian Public Policy* 9: 174–80.

Boadway, R.W., and D.E. Wildasin. 1984. *Public Sector Economics*. 2d ed. Boston: Little, Brown.

Boskin, M.J. 1973. "Local Tax and Product Competition and the Optimal Provision of Public Goods." *Journal of Political Economy* 81: 203–10.

Break, G.F. 1967. *Intergovernmental Fiscal Relations in the United States*. Washington, D.C.: Brookings Institution.

_____. 1974. "The Incidence and Economic Effects of Taxation." In *The Economics of Public Finance*, edited by A.S. Binder et al., pp. 119–240. Washington, D.C.: Brookings Institution.

Breton, A., and A.C. Scott. 1978. *The Economic Constitution of Federal States*. Toronto: University of Toronto Press.

Buchanan, J.M. 1950. "Federalism and Fiscal Equity." *American Economic Review* 40: 583–99.

_____. 1952. "Federal Grants and Resource Allocation." *Journal of Political Economy* 60: 208–17.

Buchanan, J.M., and C.J. Goetz. 1972. "Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model." *Journal of Public Economics* 1: 25–43.

Buchanan, J.M., and R. Wagner. 1970. "An Efficiency Basis for Federal Fiscal Equalization." In *The Analysis of Public Output*, edited by J. Margolis. New York: Columbia University Press.

Cairns, R.D. 1982. "Extractive Resource Taxation in Canada." In *Tax Policy Options in the 1980s*, edited by W.R. Thirsk and J. Whalley, pp. 255–97. Toronto: Canadian Tax Foundation.

Canada. House of Commons. Parliamentary Task Force on Federal-Provincial Fiscal Arrangements. 1981. *Fiscal Federalism in Canada*. Ottawa: Minister of Supply and Services Canada.

Courchene, T.J. 1983. "Canada's New Equalization Program: Description and Evaluation." *Canadian Public Policy* 9: 458–75.

Davenport, P. 1979. "Equalization Payments and Regional Disparities." Paper presented at the annual meeting of the Canadian Economics Association, Saskatoon, May. Mimeo.

Economic Council of Canada. 1982. *Financing Confederation, Today and Tomorrow*. Ottawa: Minister of Supply and Services Canada.

Flatters, F.R., J.V. Henderson, and P.M. Mieszkowski. 1974. "Public Goods, Efficiency and Regional Fiscal Equalization." *Journal of Public Economics* 3: 99–112.

Gainer, W.D., and T.L. Powrie. 1975. "Public Revenue from Canadian Crude Petroleum Production." *Canadian Public Policy* 1: 1–12.

Graham, J.F. 1964. *Intergovernmental Fiscal Relationships*. Toronto: Canadian Tax Foundation.

Meade, J.E. et al. 1978. *The Structure and Reform of Direct Taxation*. London: Allen and Unwin.

Musgrave, R.A. 1961. "Approaches to a Fiscal Theory of Political Federalism." In *Public Finances, Needs, Services and Utilization*, pp. 97–122. Cambridge, Mass.: National Bureau of Economic Research.

Musgrave, R.A., and P.B. Musgrave. 1976. *Public Finance in Theory and Practice*. New York: McGraw-Hill.

Oates, W.E. 1972. *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

Ontario Economic Council. 1983. *A Separate Personal Income Tax for Ontario*. Toronto: The Council.

Pauly, M.V. 1973. "Income Redistribution as a Local Public Good." *Journal of Public Economics* 2: 35–58.

Powrie, T.L. 1981. "Natural Resources and Federal Provincial Fiscal Arrangements." *Canadian Tax Journal* 29 (July–August): 447–502.

Scott, A.D. 1952. "Federal Grants and Resource Allocation." *Journal of Political Economy* 60: 534–38.

Starret, D.A. 1980. "On the Method of Taxation and the Provision of Local Public Goods." *American Economic Review* 70: 380–92.

Stiglitz, J.E. 1977. "The Theory of Local Public Goods." In *The Economics of Public Services*, edited by M.S. Feldstein and R.P. Inman. London: Macmillan.

Tiebout, C.M. 1956. "A Pure Theory of Local Expenditures." *Journal of Political Economy* 64: 416–24.

United States Treasury. 1977. *Blueprints for Basic Tax Reform*. Washington, D.C.: U.S. Government Printing Office.

Watson, W.G. 1984. *Report of the Policy Forum on Medicare in an Age of Restraint*. John Deutsch Memorial for the Study of Economic Policy, Policy Forum Series. Kingston: Queen's University.

2

Equitable Fiscal Federalism: *The Problems in Respect of Resources Revenue Sharing*

PETER A. CUMMING

Introduction

Over the past decade, we in Canada have experienced the traumas of three great public policy debates: energy; Quebec's place in Confederation; and constitutional reform. This paper considers a further, but hardly visible, public policy issue: equitable fiscal federalism. Exacerbated by the energy crisis, it also relates to the issue of constitutional reform.

First, some root values underlying Canadians' concept of "Canada" will be considered. The specific concept and mechanical formula of the equalization program will then be outlined. There will then be a consideration of the energy crisis 1973–81, rising energy revenues and the resulting series of ad hoc amendments to the equalization formula over the period 1974–82, bringing us to the present and a realization of the problem as it now exists and continues. We shall then consider the need for fiscal equity in nation building and conclude with a consideration of possible means to achieve this objective.

A Concept Germane to Confederation — Fiscal Equity

Economic Arrangement of Confederation

There were many reasons for Confederation, including the advantage of economic union, loyalist traditions, the spectre of Yankee imperialism and a greater defensive capability.

The basic economic arrangement of Confederation was a transfer of the key revenue sources — customs and excise — to the national government, coupled with free trade in goods among the new provinces,

thereby securing an economic union. In exchange for this surrender of revenue-raising power to the central government, the latter would make financial transfers to the provinces.

Underlying these factors was the notion of sharing the costs and benefits resulting from nationhood and ongoing national growth. Within a general objective of economic union, it has always been a national goal to reduce regional disparity and foster regional growth, and, while seeking to maximize national prosperity, to achieve an equitable distribution of benefits. (The controversial petroleum and natural gas sector itself may be used, infra, as illustrative of the point.) The Economic Council of Canada states that it considers "the sharing of costs and benefits" to be "one of the major foundations of Canadian nationhood."[1]

There are undeniable advantages gained by an economic union. It is often said that there is some loss of political autonomy at the local (in our case, provincial) level through joining such a union;[2] however, if the economic surplus so derived is redistributed and shared equitably within the union, political autonomy at the provincial level is actually enhanced, because the provincial governments receive the monies necessary to provide desired public services at the local level. Moreover, when there are generally shared social and cultural values, the loss of economic sovereignty of the constituent colonies coming together as provinces in an economic union as part of a federal state is far outweighed by the benefits gained.

Political autonomy at the provincial level, without meaningful resources to achieve desired programs, can in fact be meaningless autonomy. Where there are assured unconditional transfer payments from the central government to the provincial governments, enabling the latter to implement local programs within their constitutional range of powers, greater social and cultural autonomy is achieved at the provincial level than if union had not taken place. A system of unconditional transfer payments from the federal government, in effect, allows for decentralization in the delivery of governmental services. That is, the notion of fiscal equity is a core value for Canada, together with the core value of economic union. Canada has always been seen by Canadians as a nation that is greater than a mere collection of its parts; Canada is not merely a community of communities.

Federal-provincial economic relations since Confederation have consistently contained an element of redistribution to alleviate the fiscal needs of the less well-to-do provinces. The basic arrangement was contained in section 118 of the *Constitution Act, 1867*.[3] In return for the transfer of the receipt of customs and excise taxes to Ottawa, the federal government agreed to pay the provinces an 80 cents per capita subsidy to address the expected deficits in the provincial budgets. These payments were seen as a full settlement of all future demands upon Canada.[4]

Reality, however, immediately would prove this view to be less than prescient.

The first divergence was actually incorporated in the *Constitution Act, 1867*, section 119, whereby New Brunswick was given "an additional Allowance" of $63,000 annually for a ten-year period, the 80 cents per capita subsidy being seen as simply too low.

Only two years later, Nova Scotia pressed for, and received, its "Better Terms" to enable the province to balance its budget.[5] It was granted an extra subsidy of $83,000 annually for a ten-year period. The basic economic deal of Confederation had already proved difficult to implement.

Section 118 provided the cornerstone of "equality of treatment"[6] among the provinces. This principle would be transformed quickly into one in which statutory subsidies and grants became instances of redistribution, assuring that the less affluent provinces could provide a greater amount of services to their citizens.

Manitoba's case is a good example of this development. Its financial terms of entry into Confederation in 1870[7] were similar to those originally given to New Brunswick and Nova Scotia. However, in the next fifteen years the federal government increased the province's subsidy four times to enable it to meet budgetary requirements. To meet particular needs and satisfy political considerations, it was necessary to interpret "equality of treatment" in a broad and flexible way.[8]

Subsidies to Provinces

The remainder of the nineteenth century witnessed three developments. First, provinces were constantly clamouring for increased subsidies; the vehicles for carrying out these ends included provincial conferences, petitions and even a threat of secession by Nova Scotia.[9] These processes culminated in the *Constitution Act, 1907*[10] which gave the provinces substantial increases in grants, contemporaneously with rapidly rising federal revenues. Second, in part out of frustration, in part out of resourcefulness, provinces turned to new financial options like corporate taxes and succession duties. Third, there was an incipient awareness of the differing economic needs of certain regions arising from disparate circumstances.

Not too surprisingly, the entreaties for financial assistance arose from those provinces that had undertaken large financial initiatives — Manitoba, Prince Edward Island and British Columbia — and those that had no strong municipal tax system — New Brunswick and Nova Scotia.[11] Redistribution, in effect, occurred from the fiscally stronger provinces of Ontario and Quebec to the geographically peripheral provinces.

Further financial devices were introduced to lessen the plight of the provinces. Conditional grants were used in areas where the provincial

governments had new responsibilities but were lacking the financial wherewithal, whereas the federal government had the fiscal capacity but minimal constitutional authority, or none. Annual grants were employed in addition to the subsidies. Subsidies granted to the provinces by Parliament under the *Constitution Acts, 1867* to *1952* are still paid, being about $35.8 million for the fiscal year 1982–83.[12]

Regional problems were prevalent in the 1920s, with the Maritime provinces of greatest concern. "The spectacle of some provinces forging ahead while others languished gave rise to complaint that the Maritime Provinces were not getting their due share of the benefits of Confederation."[13] The resulting Duncan Commission in 1926 recommended "immediate interim lump-sum increases"[14] which the federal government acted upon.

The debate over Dominion control of the public lands in Manitoba, Saskatchewan and Alberta may also be viewed in terms of equitable fiscal federalism. These lands were originally retained to meet national obligations relating to immigration and settlement policy and the building of the transcontinental railway. With the completion of these great tasks, the subsidiary principle of equality of treatment reasserted itself in 1930.[15] Ironically, the western provinces had derived more from Ottawa in compensation subsidies than they would have earned had they originally owned the lands. The subsidies were not discontinued with the transfer of the public lands, an indication not simply of the objective of equality of treatment but also of the objective of raising the financial means of these provinces. That is, the transfer of natural resources was seen as a means of bringing the western provinces up toward the level of the other provinces in fiscal capacity.

Rowell-Sirois Report

As this brief review illustrates, there were evident disparities in provincial revenue-generating capacities. This matter was brought into focus by the 1940 Report of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Report).[16] The Commission recommended "National Adjustment Grants" be made to provinces whose revenue sources were insufficient to provide public services comparable to national standards without levying higher than average taxes. What heretofore had been only implicit — equitable fiscal federalism — was to be made explicit. Unfortunately, the objections of Ontario, Alberta and British Columbia stalled this initiative. They argued, on the one hand, that the war effort should be the nation's only concern at that time and, on the other, that the grants smacked of centralization. It may be of more than passing note that these three provinces were not to receive the grants. The Commission's recommendation was nevertheless an impor-

tant recognition of the nature of fiscal equity as it evolved in federal-provincial economic arrangements:

> The Commission's recommendations for payment of National Adjustment Grants, and for provision of a body to advise on future adjustment grants and emergency grants, are of major importance for several reasons. They are a complete break from the traditional subsidy system and the principles ostensibly underlying it. They make provision for the Commission's recommendations (other than those for the relief of unemployed employables) on the major subjects of public welfare, education, and provincial developmental and conservation expenditures. They illustrate the Commission's conviction that provincial autonomy in these fields must be respected and strengthened, and that the only true independence is financial security. They meet a number of provincial grievances and claims, raised under other heads.[17]

Although a formal equalization program was not put into place until 1957, the five-year tax rental agreements between the federal and provincial governments, commencing in 1942 and continuing until 1957, contained elements of equalization.

Fiscal equity has been observed as a core value in the nation's history and, apart from occasional aberrations, progress toward its greater realization has been the rule. Indeed, fiscal equity is now enshrined in Part III, section 36 of the *Constitution Act, 1982*[18] under the title "Equalization and Regional Disparities":

> 36(1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to:
> (a) promoting equal opportunities for the well-being of Canadians;
> (b) furthering economic development to reduce disparity in opportunities; and
> (c) providing essential public services of reasonable quality to all Canadians.

Some critics tend to view this provision as being of little substance given that it does not, apparently, alter the distribution of sovereign powers. However, to focus upon that is to lose sight of the presence of the notion of fiscal equity, in the expression of principles.

The Concept and Mechanics of Equalization

The fundamental goal of the equalization program, first introduced in 1957,[19] is to ensure that through unconditional grants providing sufficient financial means, all provinces will have the opportunity to provide reasonably comparable levels of public services to their citizens at

reasonably comparable levels of taxation. The objective is achieved by the transfer of federal tax revenues to the less financially affluent provincial governments.

In fiscal 1984–85, it is estimated that federal outlays for equalization will amount to about $5.4 billion.[20] This figure constitutes more than 6 percent of total gross federal expenditures, and 28 percent of cash transfers from the federal to provincial governments.[21] This represents the largest single source, more than 25 percent, of the total general revenues of the Atlantic provincial governments.[22] The equalization program is the major specific vehicle for intergovernmental redistribution of revenues within Canada.

Although subsidies have been paid by the federal government to the provinces since Confederation, the principle of equalization was first explicitly stated in the 1940 Rowell-Sirois Report. The Commission recommended unconditional "National Adjustment Grants" be paid by the federal government

> whenever a provincial government established that it could not supply Canadian average standards of service and balance its budget without taxation (provincial and municipal) appreciably exceeding the national average in relation to income.[23]

The philosophical premise for the prospective national adjustment grants was stated as follows:

> They are designed to make it possible for every province to provide, for its people, services of average Canadian standards and they will thus alleviate distress and shameful conditions which now weaken national unity and handicap many Canadians. They are the concrete expression of the Commission's conception of a federal system which will *both preserve a healthy local autonomy and build a stronger and more united nation.*[24] [emphasis added]

Underlying the Commission's view was a concept of horizontal fiscal equity, the notion that the benefits and burdens of provincial services should be reasonably comparable for Canadians in similar circumstances, regardless of their place of residence.

The Commission was of the view that the provinces had entered into a federation in 1867 whereby they would share the economic benefits as well as the costs associated with the overall growth of the nation. Moreover, it contended that without national adjustments grants this concept would be departed from by reason of the "National Policy" of 1879, of high tariff protection, which had altered the economic development of the country and its individual regions.[25] The National Policy, adopted in the judgment of the government of the day for the benefit of the nation, meant that the regions bearing the costs in part of such national policy should share in its benefits, through a redistribution of those benefits.

However, although the tax rental agreements initiated in the war years contained an element of equalization, it was not until 1957 that the Rowell-Sirois recommendation was adopted, a formal equalization program being realized with the federal treasury compensating "have-not" provinces for deficiencies in revenue-raising capacity. A successful regional development policy may well lead to a regional increase in income per capita, and equalization serves to compensate for such differences.

Since 1957, the equalization program has been implemented through a federal statute, renewed quinquennially, now called the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*, as amended.[26]

There has been apparent continuing general agreement since 1957 upon this core principle of fiscal equity. The philosophy of the concept was set forth by the then Finance Minister Mitchell Sharp in 1966, at a time of extensive legislative reformulation of the program:

> It represents one of the dividends of Canadian unity, designed . . . to enable all Canadians to enjoy an adequate level of provincial public services. Where circumstances — whether natural or man-made — have channelled a larger than average share of the nation's wealth into certain sections of the country, there should be a redistribution of that wealth so that all provinces are able to provide to their citizens a reasonably comparable level of basic services, without resorting to unduly burdensome levels of taxation.[27]

This basic notion has been repeated by successive finance ministers, and has been referred to as cooperative federalism in action. In essence, some federal tax revenues, derived in relatively greater amounts from so-called "have" provinces, are transferred to "have-not" provinces, so that Canadians in the latter provinces may enjoy a higher standard of living than would otherwise be the case. This mechanism exemplifies the underlying unstated major premise that the nation is more than simply a community of communities. Thus, "equalization" is "the glue that holds Confederation together."[28] The principle is now enshrined in subsection 36(2) of Part III of the *Constitution Act, 1982*:

> (2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

The "equalization principle" was the only item upon which federal-provincial agreement was achieved in the initial stages of constitutional negotiations, indicating the broad acceptance of its importance to Canada's federal structure and the belief that its statement as a constitutional principle would enhance national unity.[29]

It is emphasized that there is no essential difference between the stated objectives of the 1940 Rowell-Sirois Report, the Equalization

Program of 1957, the statement of Mitchell Sharp in 1966 and Part III of the *Constitution Act, 1982*. Furthermore, the Rowell-Sirois Commission expressly premised its recommendations upon a value of fiscal equity emanating from the act of Confederation in 1867.

Professor John F. Graham puts the rationalization for fiscal equalization nicely:

> One of the advantages of a federal country like Canada is that it is possible to have one's cake and eat it too, providing certain principles are understood, accepted, and applied. That is, it is possible to have the economic and political advantage of belonging to a larger country with its superior political and fiscal resources and the social advantage of the provinces' establishing their own priorities in many areas of fundamental concern in relation to their peculiar cultural circumstances. Provincial autonomy means nothing without the fiscal resources to exercise that autonomy. The economic integration of all of Canada provides the common advantage of more effective utilization of collective resources and therefore greater means to pursue both common and separate interests than would be possible otherwise. Inevitably, with or without integration, there will be substantial differences in fiscal capacity among the regions. With a single country, however, it is possible to have the advantages of a high degree of economic integration and, at the same time, through fiscal equalization, to have comparable fiscal resources for all provinces that provide the opportunity and the means of effectively pursuing provincial social policies. The resulting provincial services can differ in character but still be at comparable levels. Citizens wherever they live in the country can thus receive comparable levels of public services with comparable tax burdens.
>
> Moreover, under a system of fiscal equalization, where there are linguistic or cultural impediments to mobility of people that might preclude taking full advantage of country-wide economic integration, as in the Province of Quebec, that province does not suffer the consequences of inferior fiscal capacity in providing public services and in pursuing its provincial social policies.[30]

The mechanics of the equalization formula[31] are relatively straightforward. Initially, only three revenue sources were considered — personal income tax, corporate income tax and succession duties. In 1962 resource revenues were added. Gradually, the number of revenue sources included has been expanded; 33 sources are now taken into account.

A representative average of present taxing practices is calculated on a source-by-source basis. The national average rate of tax is determined by dividing the total revenues from a given source for all the provinces by the revenue base for that source for all provinces. It is immaterial that a particular province does not actually utilize a given revenue source: Alberta, for example, does not have a provincial sales tax, but its sales tax base is still taken into account. To provide the per capita yield, the national average tax rate for a revenue source is applied to each prov-

ince's revenue base for that source, and the resulting figure is divided by the population figure for the province. Essentially, the program measures the capacity for a province to raise revenue from the various revenue sources as against a standard.

Put simply, the equalization formula in effect worked historically as follows (ignoring the changes introduced by the 1982 amendments). Considering each revenue source separately, a province's percentage share of the total Canadian population (for example, say 3.5 percent) was compared to its share of the revenue base for the particular source (say 2.9 percent). If there was a deficiency, that is, its population percentage share exceeded its share of the tax base, the difference (0.6 percent), was multiplied by the total actual revenues (say $494.9 million) arising from that national revenue source to yield an equalization payment for that specific source ($2.9 million in the example).

Separate calculations were made for each one of the revenue sources and the resulting figures were then aggregated with an overall positive or negative amount. If the aggregate was positive, an "equalization" payment or entitlement was made from the federal treasury.

Stated otherwise, a province might have a fiscal capacity "excess" or "deficiency" in considering fiscal capacity on a normative basis with respect to each of the several revenue sources available to a province.

With the 1982 amendments to the formula, a significant change was introduced, as will be discussed in detail infra. Fiscal equalization is now determined by calculating for each revenue source the amount obtained by: taking the average per capita yield for five representative provinces (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec), subtracting from it the per capita yield for the particular province, aggregating the positive and negative amounts for all 33 revenue sources, and multiplying any positive balance by the population in the province for that year. In effect, a province's overall equalization entitlement is determined by the aggregate fiscal capacity deficiency (that is, the aggregate shortfall in per capita yield from the 33 revenue sources) for that province relative to the standard of the five representative provinces' average on a per capita basis, multiplied by the province's population. If there is an overall excess fiscal capacity (an aggregate negative balance under the formula), no equalization is payable.

The essence of the system, before the 1982 amendments, was to make a transfer of dollars from the federal treasury to provinces that were "have-not" on balance, to bring such provinces up to the average in fiscal capacity. Following the 1982 amendments, the system brings a province that is "have-not" on balance up to the average fiscal capacity of the five representative provinces.

Provinces with excess fiscal capacity, i.e., above the average do not themselves redistribute that excess capacity. However, given that federal revenues with which to pay equalization in large part come from the

federal income tax base, the residents of those provinces with excess fiscal capacity (the correlative of which is that such residents have higher personal incomes) pay collectively somewhat more federal income tax (to fund such equalization) than those in a "have-not" province. Thus, there has been an element of vertical fiscal equity present in the equalization formula as originally implemented.

In fiscal year 1973–74, for example, Quebec residents contributed 23.618 percent of federal revenue (necessary to finance equalization). Quebec received 46.363 percent of federal equalization payments for the year, resulting on balance in a net benefit of 22.745 percent of the federal gross payment. Correspondingly, for that year, Ontario received zero dollars in respect of equalization, but its share of federal revenue to finance equalization was 45.501 percent, resulting in a net contribution (net negative benefit) of that same percentage.[32] In 1980–81, Quebec received 29.13 percent (50.68 – 21.55); Ontario's share of federal revenue to finance equalization was 43.20 percent.[33]

The Energy Crisis, Energy Rents and Amendments to the Equalization Formula, 1973–82

When petroleum and natural gas were at cheap, pre-Organization of Petroleum Exporting Countries (OPEC) prices, there was no pressure upon the equalization formula. This can be said notwithstanding the peculiar constitutional position of resource revenues. First, the provinces have ownership of their resources — section 109 of the *Constitution Act, 1867* — and second, they have exclusive authority over the management and sale of publicly owned resources within the province — subsections 92(5), (13), (16) of the *Constitution Act, 1867* (now enhanced by section 92A, through the 1982 constitutional amendments). The province receives royalties from production (as consideration for giving leases to explore, develop and produce publicly owned minerals), bonus payments in giving leases and lease rental payments, all of which can be called resource revenues or energy rents. In concept royalties are, of course, very different from taxes. A royalty is the money flowing to the vendor province in consideration for the granting by it of the right to the developer to exploit the provincially owned minerals. Royalties are a return to a factor of production and are thus a component of national income. Taxes on capital and labour are a transfer of the income of these factors to government and thus are not a contribution to national income. However, from the standpoint of the receiving government, royalties have precisely the same function as ordinary taxes, that is, providing revenue to government. Indeed, where the minerals are not publicly owned, the producing province imposes taxes upon the freehold interests.

As well, a third constitutional provision, section 125 of the *Constitu-*

tion Act, 1867, must be kept in mind. Provincially owned resources are beyond the tax reach of the federal government.

Producing petroleum and natural gas reserves are very unevenly distributed across Canada, being located almost entirely within the three western provinces. Moreover, about 85 percent of the petroleum and natural gas reserves of the Western Sedimentary basin is within Alberta, and more than 80 percent of the mineral interests in Alberta lands are still owned by the province.

In the fall of 1973 the OPEC cartel presented Canada with two basic problems: first, a rising world price for oil, and second, a threat to the security of supply of oil imports into eastern Canada. For reasons that will be discussed, the rising world price necessitated a rising domestic price, although the domestic price was kept lower than the world price by federal regulation. Revenue sharing on rising domestic prices for petroleum and natural gas was the main point of conflict between the federal government and the producing provinces over the period of the energy crisis, 1973–1981, and resulted in the country not being able to pursue stated public policy objectives in respect of energy security of supply and self-sufficiency as effectively as otherwise might have been the case.

The producing provinces moved quickly in the wake of OPEC I in the fall of 1973 to raise their royalties in order to capture the energy rents as the domestic price began to move upward. The term "rents" is used here as meaning,

> . . . the surplus revenues that may be available beyond those sufficient to recover all of the investment and operating costs of the producers, including an adequate rate of return to capital from all natural resources that have some economic value.[34]

The increase in provincial royalties, deductible for federal income tax purposes, meant that the federal income tax base was correspondingly eroded.

While the federal government did try through its income tax legislation to capture some part of the energy rents, or windfall profits, for the national treasury, it was largely unsuccessful.

A first response of the federal government was to render provincial royalties non-deductible for federal income tax purposes. This meant a producer was paying tax upon a wellhead price which included "phantom income," that is, income not received but which constituted a royalty to the provincial government. The federal government later allowed a resource allowance deduction of 25 percent of resource profits (which, in effect, roughly equalled the historical percentage of price taken by the provinces by way of royalty), with the provinces cutting back upon their royalty rates at the same time. However, the resource allowance accounts for less than 60 percent of the actual provincial

government energy revenues through bonus payments, royalties upon production and lease rental payments.

Notwithstanding the above actions of the federal government, with all the deductions available in computing taxable income, the effective federal share of the wellhead price remained at about 10 percent, while the provincial share through royalties rose to above 45 percent. The two necessary federal policy objectives through its income tax legislation during the period 1973 to 1980 — first, to obtain a fair share of the energy rents from rising domestic prices for the national treasury, and second, to provide incentives for exploration and development through tax expenditures so as to achieve greater domestic supply and energy security — were working at cross-purposes. The numerous tax incentive deductions, including fast write-offs, earned depletion, the frontier exploration allowance, supplementary depletion and investment tax credits, all reduced the nominal federal income tax rate of 36 percent to an effective rate of about 10 percent. Federal price regulation pursuant to the trade and commerce power was also employed to keep a uniform domestic wellhead price ceiling lower than the world price. The effect of this was to leave some portion of energy rents with consumers through their paying lower prices than otherwise.

It must be remembered that there is no direct contribution by provincial governments in respect of resource revenues due to equalization entitlements of have-not provinces. That is, there has been no sharing of resource revenues for equalization purposes.

Therefore, the first impact of the energy crisis upon the equalization program was that higher energy prices and the consequential dramatic increase in producing-province revenues resulted in substantial increases in federal contributions to equalization. In turn, there was a secondary impact upon consuming provinces, through higher income tax rates than would have been necessary otherwise, to fund the increased federal need for revenues to fund equalization.

In contrast, consider, for example, the revenue source of personal income taxes. As personal incomes rise in certain provinces, with increased provincial income taxes, equalization is triggered; but Ottawa is funding such equalization from rising federal tax revenues in those same provinces. There is a geographical correspondence between rising provincial revenues and the source of the federal funds to finance higher equalization payments. Thus, there was an element of vertical equity present in the equalization system as it operated historically, but this element of vertical equity was lost with rapidly rising oil and gas resource revenues due to the unique geographical and constitutional factors in respect of such revenues.

The federal treasury could not support escalating equalization payments, resulting from escalating resource revenues to producer provinces. Moreover, given the nature of the scheme, increasing equalization

payments were being financed largely by Ontario. In 1973–74 Ontario contributed a net 45.50 percent (for 1980–81, about 43.20 percent) whereas Alberta and British Columbia contributed only a net total of 19.23 percent (for 1980–81 about 25.25 percent, together with Saskatchewan which in the interim had become a net contributor).[35] The other six provinces received net benefits.

Thus, rising petroleum and natural gas prices had a two-fold effect upon consuming provinces west of Quebec, supplied by Western Canada producers. Ontario, with about 35.5 percent of the country's population, and nearly 43 percent of the federal income tax base, was affected the most. First, Ontario residents made large transfers of wealth to the Alberta government because of higher prices for petroleum and natural gas, about 50 percent of the increase in prices going to the provincial treasury and the remainder to producers and the federal government. Secondly, Ontario residents also made indirect transfers (through federal income taxes) to the "have-not" provinces through federal equalization payments. The six "have-not" provincial governments (Manitoba, Quebec and the four Atlantic provinces) were net beneficiaries of rising resource revenues to the three western provinces (although in an overall sense their individual residents were relatively much poorer, given the higher prices for consumer purchases of petroleum and natural gas, and some degree of higher federal income taxes to support increased equalization). This phenomenon may explain in part why provincial governments, with the exception of Ontario, tended to support the three western producing provinces throughout the energy crisis. Higher prices and energy rents to the producing provinces meant more dollars to all provincial governments except Ontario, although the increased equalization payments to such governments did not nearly offset the higher cost of energy to the residents of those provinces.

Resource revenues by 1981 accounted for over 30 percent of equalization payments, but only 7 percent of provincial revenues to be equalized.[36] This was due to the geographical concentration of those revenues in the three western provinces, particularly Alberta.

With rising energy prices, triggering rising equalization, increasing federal deficits and the constitutional and political inability of the federal government to tax provincial resource revenues, the principle of fiscal equity underlying equalization was departed from, with pragmatism dictating adjustments which would solve the problem for the near term even if, in the longer term, the federal fabric might be harmed. Indeed, this question was really not addressed. The more visible, direct impact of energy prices and energy rents upon the national economy, rather than the secondary, less obvious impact upon equalization, was paramount in developing federal energy policy.

Insofar as equalization is concerned, the common theme to federal

policy became simply that of cost-control. If world prices for oil had prevailed in Canada in 1974, equalization payments would have tripled and federal financing would have required a 25 percent increase in the personal income tax rates.[37] Even with a federally regulated domestic price ceiling for oil, which kept energy rents to the producing provinces down significantly, the federal government considered it necessary to amend the equalization formula. Given significant imports in eastern Canada at rising world prices, with resale after refining at the lower uniform domestic price ceiling, the federal government was compelled to allow the domestic price to rise and narrow the gap between the domestic and world price in order to reduce import compensation payments from the federal treasury to refineries importing oil in eastern Canada. However, as the domestic price for oil rose, further equalization payments were triggered, and the manner in which the resultant cost to the federal treasury was controlled was through amendments to the equalization formula.

The first amendment to the formula was made in 1974.[38] Commencing with fiscal 1973–74, a restriction was placed on resource revenues entering the formula: revenues prevailing in 1973–74, plus one third of revenues above the 1973–74 levels. Thus, the principle of full equalization was departed from, on the simple, quite pragmatic basis of federal cost control.

However, pressures due to escalating energy rents continued. The 1977 revision of the Act brought two further changes.[39] The non-renewable resource revenue sources were now set on a basis of inclusion of a flat 50 percent of all revenues therefrom. This did result in slightly greater equalization than under the formula, as amended in 1974, but still departed significantly from full equalization. Again, the implications of the cost of the existing formula were addressed, rather than the appropriate level of payments due to underlying principles.

The second amendment provided that equalization payments resulting from renewable and non-renewable resources would thereafter be limited to one-third of the total entitlements. Thus, although the federal government was slightly more generous with the percentage of energy revenues included within the formula, an overall capping was imposed with respect to resource-related payments.

Unfortunately, by 1978 it was clear that the federal government was continuing to miscalculate grossly equalization payments. Alberta's annual resource revenues had jumped from $340 million in 1972 to nearly $4.7 billion in 1979.[40] The Iranian revolution had also launched OPEC II with a new acceleration in energy prices. The final estimate for 1977–78, completed in 1979, showed a large positive entitlement for Ontario. Because of energy revenues, Ontario was technically transformed into a "have-not" province.

Two more amendments were introduced in Parliament in 1979,[41] but because of the two changes of government they were not enacted into law until 1981; but by amending the regulations, the same result was achieved as of fiscal year 1977–78. The federal government rendered Ontario ineligible by means of a "per capita income override": any province having a per capita income in excess of the national average in the current fiscal year, as well as in the two preceding years, was thereby excluded from equalization payments.

Another amendment was to delete entirely one energy revenue source, "Sales of Crown Leases," which accounted for about five percent of all entitlements in 1979–80. By the exclusion of this source, a significant item of provincial fiscal capacity was simply ignored, because of its impact upon entitlement.

Over the course of the five-year period 1977–82 under the 1977 Act, Ontario would otherwise have been entitled to about $1.347 billion but for the per capita income override.[42]

Such entitlement might seem inappropriate at first glance, given Ontario's position, both historically and present, of affording its residents a high standard of public services and high standard of living. The province is above most people's notion of basic services levels. Recall, however, that the concept of equalization as expressed historically was to bring a disadvantaged province to "average standards" (Rowell-Sirois) and provide it with "reasonably comparable" services at normative tax levels (Finance Minister Sharp). It was not simply to ensure that services come up to a reasonable standard in an objective sense.

Thus, if Ontario were entitled to equalization (i.e., ignoring the per capita income override), given its population of almost 36 percent of that of the nation, coupled with virtually nil oil and natural gas revenues within the province, and if the six natural resource revenue sources were considered on a basis similar to the other 26 revenue sources for 1979–80, Ontario would have had an approximate $1,750 million positive entitlement generated because of those six natural resource revenues which, offset against an overall negative entitlement of some $687 million for the other 26 revenue sources, would have resulted in about $1 billion as an overall entitlement.[43]

At this point, Ontario was significantly disadvantaged in respect of the operation of the equalization system. Though precluded from receiving equalization, it contributed some 40 percent of the $889 million eligible for energy-related equalization through federal income taxes. Ontario was the only province with a net negative energy-based equalization balance (of $345 million). Alberta was left with a surplus of $3.98 billion from energy revenues, after its contribution, though federal income tax paid by its residents was subtracted.[44]

Equalization payments would end legislatively if a new program was

not enacted by March 31, 1982, the expiry of the then five-year legislated period. There were concerns by all provincial governments as to what the new formula might be.

The federal government initially suggested that Ontario's fiscal capacity be regarded as the standard for equalization entitlements.[45] It sought thus to obfuscate the issue of energy revenues by including all energy rents sources within the formula on an equal basis, but by then employing Ontario alone as the representative standard. This would effectively exclude energy rents from triggering equalization.

Furthermore, by entering into a federal-Alberta Energy Pricing and Taxation Agreement (EPTA) on September 1, 1981, and with the other two western producing provinces subsequently, there was an implicit undertaking by the federal government not to attack provincial energy rents to fund equalization.

The November 12, 1981 federal budget proposals suggested, first, the removal of the per capita income override which was visibly directed against Ontario, and second, the removal of the one-third resource cap. The adoption of Ontario as a representative provincial fiscal capacity standard would have allowed this measure. In effect, by sleight of hand, energy rents would be made irrelevant to the equalization formula. The federally proposed "improved formula" was indeed that, in terms of saving expenditures from the federal treasury, but was harmful to any resolution of the larger, silent issue of fiscal imbalance or fiscal inequity.

The proposals in the federal budget of November 12, 1981, were met by provincial hostility. The provinces argued that with only five months to the expiration of the then current program, there was insufficient time to negotiate and try and reach a consensus. As well, the "have-not" provinces were skeptical about the adequacy of the Ontario standard, given the ill health of the Ontario economy. Moreover, the effective exclusion of energy rents from the formula would cost the provinces several billion dollars in equalization over 1982–87. Full equalization up to the national average would have required total equalization payments of about $10.2 billion in 1982–83, but only about $4.5 billion if the 1977–82 formula, as amended, was retained.[46]

The Ontario standard was dropped by the federal government in discussions in February 1982, with an averaging formula covering five provinces — Ontario, Quebec, Manitoba, Saskatchewan and British Columbia — being substituted. The eventual legislation of March 31, 1982 adopted this standard. This approach reduced the vulnerability of the "have-not" provinces to the performance of the economy of a single province and did bring in a component, albeit modest, for energy rents, through the inclusion of Saskatchewan and British Columbia.

The exclusion of Alberta from the five-province representative average meant that the residents of the four provinces then not receiving equalization, being British Columbia, Alberta, Saskatchewan and

Ontario (the first three provinces having an aggregate negative entitlement and the fourth, Ontario, being subject to the personal income override) would not, under the new formula, have to pay federal income tax to fund equalization payments to the six "have-not" provinces, triggered because of rising resource rents to Alberta. In particular, this removed an injustice to Ontario present in the previous system. In terms of the overall system, however, both vertical and horizontal fiscal equity had been further compromised.

Vertical equity was still distorted by the mechanics of the formula as there was no real sharing of the energy rents of the richest province. Even more significantly, horizontal equity was greatly eroded through the series of amendments from 1974 to the present.

Equalization payments grew by an average of 16 percent per year from 1971 to 1982, including a 29 percent per annum growth rate for the period for energy-related equalization.[47] Through a series of ad hoc amendments, the equalization system has been rationalized from the standpoint of costs. However, federalism has been compromised through the continuing departures from the basic cornerstone principle for which equalization stands. There is now only partial equalization, in terms of bringing a "have-not" province up to the per capita national average in fiscal capacity, with consequential significant differences in fiscal capacity and, in turn, substantially different levels of tax rates and public services.

Some will argue that it is enough to equalize to the extent of only bringing disadvantaged provinces up to a reasonable objective standard and that the five-province representative average is such a standard. In other words, equalization is sufficient if it brings provinces to a reasonable standard of services at reasonable tax rates. Nevertheless, this falls short of the historical concept, and the concept as expressed in subsection 36(2) of the *Constitution Act, 1982*, which stipulates that the standard, germane to nation building, is to enable provinces to have "reasonably *comparable* levels of public services" at "reasonably *comparable* levels of taxation" (emphasis added). The original draft version of subsection 36(2) read: "Parliament and the Government of Canada are committed to taking such measures as are appropriate to ensure that provinces are able to provide the essential services . . . without imposing an undue burden of provincial taxation."[48] The "reasonably comparable" wording formulation in the final version, rather than the more restricted wording of "essential public services" and "undue burden" seen in the first draft, supports the argument that the concept of equalization extends beyond one of simply ensuring the provision of "basic" services, to a broader notion of equity.

The root cause of the problems in respect of the formula has been the inclusion (albeit partial) of energy revenue sources under provincial control. Yet if the principle of fiscal equity underlying equalization is to

be maintained, this means that a comprehensive formula for measuring provincial fiscal capacity must in turn be maintained. A dollar of fiscal capacity is a dollar of fiscal capacity, whatever its source. To achieve horizontal equity there must be a full inclusion of all revenue sources in any formula and the overall system must function in a way whereby energy rents directly or indirectly fund the part of equalization payments attributable to energy rents.

The Need for Fiscal Equity in Nation Building

Economic Union — Efficiency

There is an animated debate at present underway with respect to the very utility of equalization-type payments in an economic context. On the one hand, Professor Thomas Courchene, chairman of the Ontario Economic Council, has put forth the view that federal transfers distort the otherwise normal allocation of resources in the economic union by acting as a disincentive to the mobility of labour and capital.[49] On the other hand, the Economic Council of Canada has stated that such programs are basic to a smooth-running economy.[50] These perspectives merit brief elaboration.

In the Courchene view, the types of payments under discussion make poorer provinces more dependent on federal assistance and even less inclined to alter conditions creating the underdevelopment. Equalization payments account for approximately 25 percent of the provincial government budgets of the Atlantic provinces. The major consequence which is perceived is an upsetting of the natural adjustment mechanisms, equalization payments being seen as permitting the recipient provinces to sustain higher consumption levels than otherwise possible. Resource allocation is distorted, the argument goes, via the disincentive to labour and capital to move to areas of greater efficiency.

Diametrically opposed are the analyses of, for example, the Economic Council of Canada and John F. Graham. The conclusion of the Economic Council, in *Financing Confederation Today and Tomorrow*, is stated as follows:

> Contrary to allegations that the Equalization Program leads to an inefficient allocation of resources in the economy, our analysis has shown that such a program is essential to the efficient functioning of the economy. If factors of production are to be allocated as productively as possible, an equalization program is needed to offset the effects of provincial net fiscal benefits on the movement of such factors. Our research has shown that such fiscally induced migration does take place in Canada, although its extent varies by income group and region.
>
> It needs to be emphasized that efficiency considerations call for complete equalization of net fiscal benefits, including those related to resource reve-

nues, while equity considerations call for something less if we choose to regard Crown-owned natural resources as a provincial property right. Generally, therefore, the issues involved in the equity/efficiency trade-off, as it affects the various Canadian regions, are clearly relevant to the design of federal-provincial fiscal arrangements.[51]

Graham's thesis is that equalization and similar payments help to forestall not only any tendency toward the movement of well-allocated resources from low- to high-income provinces/regions but also any impediment to the movement of capital and labour from high-income to low-income provinces/regions if such resources would be more beneficially located there:

> Without transfers, differential fiscal treatment will exert pressure indiscriminately on factors to move from a poor province or locality, even factors that are well located there, and will inhibit the inward movement of factors from richer provinces and localities, even ones that would be better located in the poor province or locality.[52]

However, it should also be noted that there will be some capitalization due to differences in net fiscal benefits among provinces, through increased land values and housing prices, and to this extent there will be a counterbalancing tendency.

If there is a point of consensus between the competing viewpoints, it is that this debate is not limited to a sterile economic context. As Courchene states:

> In the final analysis, the solution will no doubt be political and will take account of two aspects that have not as yet been mentioned in this paper, namely the constitutional framework and, as important although clearly related, the degree of centralization or decentralization of power within the federation.[53]

Notwithstanding the definite view espoused by the Economic Council of Canada, this subject matter requires more empirical study, as Courchene mentions in his most recent comments upon the subject.[54] Conversely, however, the more that transfer payments become a political issue, the less will be the significance attached to such further research.

As the issues involved are fundamental to the fabric of Canada, economics will be a secondary concern in any final determination. The nation's sense of fiscal equity, together with political realities, ultimately will determine the matter. However, Courchene himself has emphasized recently that "the *potential* exists for equalization to enhance efficiency," his argument being that Canada's recent equalization programs in practice cannot be defended on this basis.[55]

Fiscal Equity — Fairness

As we have seen, equalization is founded upon the historical Canadian value of fiscal equity as seen in the language of subsection 36(2) of the *Constitution Act, 1982*. This provision asserts that all Canadians, wherever they reside and whatever the degree of choice present in that decision as to the place of residence, should receive a reasonably comparable level of basic public services at reasonably comparable rates of taxation. The qualifier upon horizontal equity in terms of fiscal capacity is only that of reasonableness in terms of approaching the norm.

The Rowell-Sirois Commission was of the view that equalization was a trade-off for tariff benefits to central Canada through the "National Policy" and that there was an implicit contract in Confederation whereby provinces would share benefits and costs associated with the overall growth of the nation. Ontario, the prime benefactor of the National Policy of 1879, will have contributed more than $20 billion in federal income taxes to fund equalization in the period 1957–87.[56] Whether this was too much or too little in quantitative terms is beside the point. The goal of fiscal equity has been pursued. Equalization has been an appropriate and successful mechanism in strengthening the fabric of the Canadian nation.

The Case of Alberta

Let us consider historical energy policy in Canada in the context of this view. Alberta, as well as the other producing provinces, has benefited from the historical concept of fiscal equity in the creation of its resource wealth.

First, Alberta lands were federal lands until 1930. One reason the lands were transferred was in response to the argument of a need for revenue sources to help bring Alberta up to the national norm. Second, through the most favourable national tax expenditures given to any industry, the non-renewable resources industry was built up over the past sixty years. Third, through the National Oil Policy of 1961, the major expansion of the Alberta petroleum and natural gas industry was achieved. Under this policy, Ontario was made a captive market for Alberta oil at higher than world prices, which situation prevailed to 1973 and OPEC 1. Fourth, the federal government made possible the pipeline to deliver natural gas to eastern Canada, through financial guarantees and subsidies, which not only benefited Alberta as supplier but also Ontario and Quebec as consuming provinces, through giving greater security of energy supply and access to a cheap energy source. The then minister of trade and commerce in the St. Laurent government, C.D. Howe, "likened the building of the Trans Canada natural gas pipeline to the centrepiece of Macdonald's policy, the Canadian Pacific railway," both being seen as

essential to the building of an east-west economy.[57] All of the above-stated federal policies and actions were founded in part upon a national value and objective of reducing regional disparities by fostering regional growth, that being a corollary to the concept of equitable fiscal federalism. As well, Alberta itself was the beneficiary of equalization while it lacked average per capita fiscal capacity, until 1962, when it achieved a mature natural resources industry.

These historical energy sector policies were seen at the time of their formulation as being largely to the economic benefit of the western provinces but also as a necessary component of equitable fiscal federalism. Moreover, with the hindsight gained because of the energy crisis of the 1970s, it is clear they have been a boon to the nation as a whole. It would be consistent with the historical concept of fiscal equity, as evidenced by historical energy sector policies and the equalization program pre-1974, now to reformulate the equalization system through providing for the redistribution of energy rents.

Alberta argues that the federal fiscal take in respect of energy taxes (in particular, through the petroleum and gas revenue tax)[58] via the National Energy Program, coupled with domestic price ceilings established by the *Energy Administration Act*,[59] has meant that there has been a sharing with other Canadians, and that the federal government uses its revenues from provincial resources for expenditures to the benefit of all Canadians. Indeed, the Economic Council of Canada in *Financing Confederation*, emphasized that the three western provinces lost about $13.5 billion in 1980 in foregone rents due to federally regulated low domestic prices.[60] The Council stated:

> A point that bears repeating is that the amount of net redistribution that occurs as a result of the inclusion of natural resources in the equalization formula is of minor significance — after account is taken of the cost of financing this additional payment by the federal government — compared with the implicit redistribution through other mechanisms. For example, of the $12.7 billion that was redistributed from Alberta to other provinces, only $114 million was accounted for by its resource-related contribution to the Equalization Program.[61]

There can be no doubt that the residents of Ontario and the other non-producing provinces have gained significant benefits through the payment of lower than world oil prices over the period 1974–85.

This argument by Alberta may be valid, as far as it goes, but it is not responsive to the larger question of fiscal equity. First, through these twin measures of taxes and price ceilings, there has been only a partial sharing of resource revenues. It is estimated that, after redistribution, the net benefit per capita in Alberta in 1980 from resource rents was more than three times as great as the average for the nation.[62] Alberta, with about 9.5 percent of the national population, takes the greater share of

current revenues. Second, resource revenues arise from consumer payments. Producers receive their revenues from all Canadians (and from exports of natural gas and petroleum), but there is only a relatively small redistribution of revenues through the national government.[63]

Alberta would counter this argument with two assertions: provincial ownership of natural resources implies that the benefits of those resources accrue to the province; as these resources are non-renewable, such benefits should accrue, in the main, to Albertans.

However, arguments can be advanced against this position. First, provincial ownership and control was historically related primarily to the notion of equality of treatment, and the ownership of lands within a province was seen in the context of "matters of local interest," what we might now call socio/environmental issues, not economic benefits. In so far as economic benefits were perceived as becoming important at a later time, the argument of the western provinces in the 1930s was to gain control of the economic benefits from resources to bring them up to the Canadian norm. Second, domestic energy revenue benefits arise indirectly from the fact of the OPEC cartel control. The bulk of the revenues represents a monopoly or windfall profit, with the factor of ownership in itself being irrelevant in price, and hence benefit, determination. Moreover, resource revenues are unique provincial revenues in that they are largely collected from individuals who are non-residents of the revenue-taking province.

Third, Alberta has, in a total sense, a vast quantity of non-renewable resources. Resources are, in reality, a function simply of cost and technology and, looked upon in this manner, Alberta has more petroleum and natural gas than ever before. Consider the Syncrude plant at Fort McMurray in Alberta. With the most impressive modern, high technology one can imagine, some 125,000 barrels a day are produced at a profit, representing about 7.5 percent of Canada's daily oil requirement. The billions of barrels of recoverable reserves of the oil sands represent the next generation of wealth from natural resources in Alberta. When non-conventional sources are taken into account, Alberta has more recoverable oil and gas than ever before. There are one trillion barrels of oil in the oil sands, although only a relatively small part of that will be recoverable. However, such oil was not a feasible resource at all pre-OPEC, because of cost and lack of technology. Natural gas reserves have increased by about 50 percent since 1970. Moreover, with the shift to an off-oil, and on-gas policy through the National Energy Program, and further probable natural gas exports, Alberta will receive some increase in energy rents from natural gas. However, it is true that Alberta's conventional oil reserves have been diminishing for the past fifteen years, with the exception of the past year; hence low-cost, high windfall-profit oil has a limited life.

At present, Alberta has the lowest provincial tax rates, the highest level of provincial services, a heritage fund with $13 billion and no provincial deficit.

It was asserted at the beginning of this paper that centrifugal forces had developed in Canada in 1973 with the impact of OPEC I. At the 1971 Victoria Conference on the Constitution, natural resources were not mentioned as a topic, and all provinces were satisfied with the then existing Constitution. Yet ten years later the Heritage Fund had become in symbolic terms to Alberta what Bill 101 was to Quebec. Finally, even if resource revenues can be said to accrue largely to provincial governments, logically by virtue of ownership and constitutionally by virtue of the distribution of powers, the rule should be changed, given the need for equitable fiscal federalism, through the introduction of an appropriate equalization system.

An analysis of the history of energy policy in Canada shows that such policy is not different from the concept at Confederation in 1867 and the later "National Policy" of 1879, which gave rise to the need for equalization on equity grounds — a sharing of costs and benefits. Historically, energy policy and equalization policy were perceived as necessary to nation building, with costs and benefits. Both, therefore, call for redistribution of benefits to achieve equity.

The Case of Newfoundland

The Newfoundland-Canada offshore issue mirrors potentially the past and present problems experienced with the western producing provinces since the inception of OPEC in 1973. As well, the 35-year history of Newfoundland in Confederation with Canada reflects the traditional value of fiscal equity. Given first, national ownership of the continental shelf and sole constitutional authority in respect thereof being with Parliament under sub section 91(1A) and the peace, order and good government clause of the *Constitution Act, 1867*; second, the fact that more than 90 percent of energy industry expenditures in the continental shelf off the east coast have come from the national treasury through tax subsidies and now petroleum incentive payment grants; and third, the fact that close to 30 percent of Newfoundland's budget for 35 years has come from federal general purpose transfer payments, pursuant to a national concept of fiscal equity, one can argue against the transfer of constitutional authority in respect of offshore resources to Newfoundland as a province. To transfer the offshore may mean that Newfoundland's per capita fiscal capacity could become several times greater than that of other provinces, such as Prince Edward Island or New Brunswick. If there are future significant offshore discoveries, and if there is an OPEC III whereby prices again accelerate, Newfoundland,

with 584,000 people — 2.3 percent of Canada's population — could be rendered the wealthiest province in the union from the standpoint of per capita fiscal capacity.

The Rt. Honourable Joe Clark, as prime minister, made a commitment in 1979 to transfer ownership of the adjacent offshore continental shelf to Newfoundland and to amend the Constitution whereby such lands would be brought within the province so that it would have the same legislative authority over these lands as it enjoys in respect of onshore lands presently within its boundaries.[64] Prime Minister Brian Mulroney, while Leader of the Opposition, said that Newfoundland should be entitled to collect resource revenues from the adjacent offshore as if it were within Newfoundland's boundaries and that if the provinces wish to have a constitutional amendment in respect of an offshore agreement, his government would support such an amendment before Parliament.[65]

Pursuant to these commitments, the Atlantic Accord on offshore oil and gas development was signed February 11, 1985 by the Newfoundland and federal governments.

As has been emphasized in this paper, a basic theme of Confederation has been the pursuit of fiscal equity, a value now enshrined in Section 36 of the *Constitution Act, 1982*, whereby there is a redistribution of the wealth of the country to the "have-not" provinces. Newfoundland itself has been a prime beneficiary of federal transfers through equalization, health care, post-secondary education, and social assistance program monies, which constitute more than 55 percent of the provincial government's revenues, and have totalled about $8 billion since 1949. The nation, quite properly, has shared its wealth with Newfoundland because its fiscal capacity has been below the national average, so that its residents can have reasonably comparable public services at reasonably comparable tax rates.

However, the federal government has now agreed that Newfoundland can take the economic rents from offshore development just as if the offshore constituted provincial lands. If there are further significant offshore discoveries, and if there are further world price increases due to OPEC, both of which are quite possible in the long term, then Newfoundland could quite possibly have the highest per capita fiscal capacity in the nation. Newfoundland might well be 10 to 20 times wealthier than say, Prince Edward Island, New Brunswick or Manitoba. In contrast to our history since Confederation, which has seen the reduction of regional disparities in fiscal capacity, the Atlantic Accord may well create growing regional disparities. Newfoundland is not obliged to share its rising wealth with the rest of Canada; and to get even a part of it, a federal government would be forced to repeat the federal-provincial conflicts seen in Alberta and the western producing provinces over the past decade.

Thus, the offshore agreement has planted the seed for future ine-

quality and inequity, notwithstanding that the wealth is generated upon federal lands and more than 90 percent of the cost of the development will have come from the national treasury through tax expenditures and federal grants. All the people of Canada have paid for the cost of offshore development, but it is only the provincial government representing 2.2 percent of the population that will receive the economic rents, no matter how sizeable they may be.

In contrast, the approach of the Canada–Nova Scotia Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing signed March 2, 1982 and enacted into law in June, 1984, (to be discussed infra) by the Trudeau government would give to Nova Scotia all offshore revenues until it achieved 110 percent of the national average in fiscal capacity, and there would then be a sharing of revenues until the province achieved 140 percent of the national average, whereupon all additional revenues would flow into the federal treasury for the benefit of all Canadians. However, the federal Minister of Energy, Pat Carney, has stated that she will reopen the Nova Scotia agreement, so that it will be given the benefits extended to Newfoundland through the Atlantic Accord.

Newfoundland has also been assured that it will receive offset payments for much of the equalization it would otherwise lose because of rising fiscal capacity due to offshore development, for some 12 years after production from Hibernia commences. Thus Newfoundland and Nova Scotia (the only two provinces with a real promise of significant offshore oil and gas riches) are also to be placed in a preferred position under the equalization program. For example, if Manitoba's economy prospers at a higher rate than the national average, its equalization entitlement is correspondingly reduced.

Moreover, the federal government has undertaken to support a constitutional amendment to entrench the agreement if Newfoundland has the requisite support of the other provinces. Although the glow of cooperative federalism evidenced by the signing of the agreement may be appealing in the short term, the truth, in the long term, is that the offshore settlement represents a new, potentially centrifugal force for Canada as a nation.[66]

Quite clearly, no Canadian wants Newfoundland to be maintained in a state of dependency upon federal transfers. However, Newfoundland should achieve the national average, or better, in per capita fiscal capacity, not by constitutional right in respect of the offshore but by national policy. This is the approach of the present Canada–Nova Scotia Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing. The federal government may wish in the future that revenues significantly in excess of the national average per capita fiscal capacity be utilized by the national government for national purposes, including the funding of federal government activities and services. At the least,

such revenues should be shared for purposes of equalization. Should Newfoundland be given constitutional authority over the offshore, it would be politically and constitutionally difficult for the federal government to force a sharing of energy rents. In the event of rapidly rising prices and windfall profits, there could be a revenue-sharing struggle like that seen between the federal government and the western provinces over the period 1973 to 1981.

While the proposals of this paper are important in all events, they have even greater significance if the coastal provinces are ever to be given constitutional authority over the adjacent offshore. In such event, it is appropriate that there be in place some mechanism whereby coastal provinces share their energy rents with those provinces below the national average in per capita fiscal capacity. The above points made in the context of the Newfoundland-Canada offshore dispute have particular relevance also in respect of Yukon and the Northwest Territories becoming provinces at some future date, given the petroleum and natural gas potential of the continental shelf underlying the Beaufort Sea. Yukon has a population of about 23,000 people, and the Northwest Territories about 46,000 people. With populations of less than 0.1 percent and 0.2 percent respectively of Canada's total population, as provinces these jurisdictions could have very high per capita fiscal capacity with significant offshore development.

The Equalization Program Today

This paper asserts that the amendments through the 1970s distorted the equalization program by moving it away from the underlying premise of full fiscal equity. The equalization program does not today attempt to realize its historical objective — expressed in subsection 36(2) of the *Constitution Act, 1982:*

> Parliament and the government of Canada are committed to the principle of making equalization payments *to ensure that provincial governments* have *sufficient revenues* to provide *reasonably comparable* levels of public services at *reasonably comparable* levels of taxation. [emphasis added]

Did the amendments through the 1970s also have the effect of moving the equalization program away from the more limited, contemporary expression of equalization (due to the five provinces' representative average standard) namely, being just an aspect of full fiscal equity that all Canadians should have a reasonable (but not "reasonably comparable") level of public services in an objective sense, at a reasonable (but not "reasonably comparable") level of taxation? It is very difficult to say, in view of the absence of standards against which to measure public services. Moreover, the cost of public services has not increased to keep abreast with energy prices. Some might even claim that equalization falls

short of the realization even of a limited, contemporary objective of bringing disadvantaged provinces up to a reasonable objective standard.

Expenditures in 1972–73 by all provinces were roughly the same per capita with roughly equal tax rates. Alberta's per capita expenditures for 1981–82, however, were about $6,861, compared with Prince Edward Island's at only $1,460. The difference in tax rates has become wider as well.[67] Considering the comprehensive tax base of the equalization system, but taking 100 percent of resource revenues into account, it is evident that there has been growing regional disparity in fiscal capacity throughout the energy crisis, 1973–81. With the national average being 100, Alberta's tax base per capita rose from about 137 to 247 over the period 1972–73 to 1980–81, while Prince Edward Island's fell about 58 to 53.[68]

Taxes can be looked upon as revenue necessary to provide public services, yet to the extent that a government can gain revenues from sources other than personal or consumption taxes, such as from energy rents through public ownership, the disparity of public services is compounded because they are provided without taxation. For example, Alberta today provides the highest level of public services at the lowest tax rates.

The clear statement of principle set forth in subsection 36(2) of the *Constitution Act, 1982*, is not fully defined. How does one measure the degree of success of an equalization formula?

What are basic services, particularly given variables of cost and population from area to area? Current fiscal capacity to raise revenues is adopted as the measurement, but what about the problem of provinces having different levels of services because of different wealth historically? As a disadvantaged province historically, undoubtedly much of Alberta's relatively recent public wealth has gone to providing an infrastructure of public goods and services that residents of Ontario have enjoyed for some time. As well, given greatly varying populations, some provinces of small population are put to a disadvantage through the measurement of fiscal capacity on a per capita yield basis. Yukon, as a vast "province" of rugged and remote terrain, would require considerably more in expenditures to provide even basic provincial public service, than some other provinces. Yet with a small population, and high fiscal capacity with offshore development, Yukon might well be technically rendered a "have" province. Even in provinces with large populations, the per capita basis may be inadequate under some circumstances, due to the differences in the age structure of the population or because of the view as to the nature of basic services due to cultural or language differences. The equalization formula does not look at expenditure needs.[69]

It is sometimes asserted that equalization looks just to the provision of "some basic level of public services" and is not addressed to a broader concept of fiscal equity. However, it is submitted that equalization is

more than the mere financing of some basic level of public services in all provinces. When first articulated in this context by the then Finance Minister Mitchell Sharp, it was as the objective achieved by a formula of full equalization. Sharp also spoke of provinces "having reasonably comparable services." A basic level of public services was the limit of what could be foreseen by full equalization at the time of his statement.

The provision of basic public services is but one rung up the ladder of fiscal equity. What if greater equalization provides more than "some basic level of services in all provinces" but rather would tend to give "reasonably comparable" services at "reasonably comparable" tax rates? The divergence in possible standards was not foreseen in the pre-OPEC days of 1967. This paper asserts that the core principle is fiscal equity, with equalization up to the national average per capita fiscal capacity being the means (if through a technically imperfect formula) by which to achieve equity. The most that could be imagined in 1967 through such achievement was "some basic level of public services in all provinces." Section 36 of the *Constitution Act, 1982*, with its "reasonably comparable" formulation, is more apt for the underlying equity concept (although one must query whether these fine distinctions were seen at the time of constitutional formulation).

If one sees the goal as simply "some basic level of public services in all provinces," then the inclusion of massive energy rents, without any amendments of the original formula might, admittedly, result in over- rather than under-equalization. Some observers accept the limited view of the principle of equalization.[70]

In 1972–73, before the OPEC price shock, national average expenditures per capita on public services provided by provincial and local governments were $1,092; in the seven "have-not" provinces, $1,079.[71] The then Finance Minister John Turner remarked:

> Our . . . equalization program will clearly be a more powerful weapon in combatting the effects of *regional disparities in income* and represents a further *significant move* toward the achievement of a regionally balanced fiscal policy.[72] [emphasis added]

The present equalization program will result in total payments of about $5.4 billion per year for 1984–85.[73] With energy rents equalized in full, payments might rise significantly, as will be discussed infra.

Let us assume that there is today a reasonable (if not comparable) level of public services throughout Canada at reasonable (if not comparable) taxation rates. Has the impact of natural resource revenues, in economic and political terms, had such a dramatic effect upon Canada that there should be a level of fiscal equity over and above this more limited notion of equalization? One can argue that the mechanism should strive to horizontal equity, to distributive justice, toward an equal sharing of fiscal capacity. It can also be argued that there are merits from

the standpoint of the national economy to recycling energy rents. Courchene attacks the "representative five-province average" system as being relatively inefficient because the resource revenues that are a major source of differential net fiscal benefits across provinces have been downplayed in the new formula.[74]

On the other hand, there are arguments for less than an equal sharing of fiscal capacity. First, if there were to be a total loss to a producing province of energy rents in excess of national average fiscal capacity, there would be less self-interest in developing provincially-owned resources. While development would indirectly benefit the provincial treasury through increased employment and business activity and, hence, increased income taxes, the significant present benefit of resource royalties would be lost. Second, the fact of provincial ownership is a reality which suggests to many people that the provincial government owner should receive more than the nation as a whole through the federal government from that province's energy rents, in per capita terms. Third, while the equalization program has served to reduce regional disparities, the approach has not been to equalize provincial fiscal capacities. While "have-not" provinces were brought up to the norm on a per capita basis, and while the residents of the wealthy provinces did contribute in respect of such equalization through increased income taxes, provincial governments in wealthy provinces were still left with fiscal capacities above the norm.

With price de-regulation (now announced federal government policy)[75] as petroleum prices increase, there may be a combined inflationary and recessionary impact upon the national economy. Increased oil prices make sense, first, to reduce economic disparities occasioned by having a lower domestic price as compared to the international price and, second, to increase conservation due to decreasing consumption because of rising prices. If some part of additional resource revenues to the public sector were recycled back through lower taxes (say through individual refundable tax credits), then any inflationary/recessionary impact could be offset, or at least modified. A full equalization program would tend to have the same effect through a reduction of provincial taxes. That is, as provinces receive increased equalization payments, they can lower their provincial tax rates. There is a recycling, anti-inflationary effect.

It might be politically more attractive to have some energy rents move to the federal government and be recycled directly to all individuals (say as energy tax credits). By having individuals, rather than provincial governments, receive resource revenue benefits, some argue that such a scheme would be less offensive to producing provinces and more acceptable to Canadians generally, thereby being more politically attractive to the federal government. Resource revenues are collected largely from non-residents of the revenue-taking province. However, as all provinces

except Alberta have a serious deficiency in revenues to meet expenditure needs for provincial services, it is arguable that resource revenue benefits should be transferred directly to provincial governments. Such considerations are the subject matter of the following part of this paper.

Proposals for Reformulating the Equalization Program

Courchene and Copplestone propose a two-tiered system with an interprovincial revenue-sharing pool for resource rents sources.[76] The first tier entitlements would be as calculated under the existing equalization formula, with Ottawa to fund the payments. The second tier would embrace resource revenues. Entitlements would be determined with respect to the deficiency or surplus of a province's per capita resource revenue compared to the national average per capita resource revenue. Provinces with positive entitlements would receive payments from the interprovincial revenue-sharing pool, but such payments would be only a percentage of what would be necessary to redistribute fully such rents. The proposal is dependent upon periodic, voluntarily agreed-to payments by the producing provinces. At a 50 percent level of sharing, Alberta would have paid out $1.106 billion in 1979/80. Alberta's per capita revenue, at about 163 percent of the national average, would have fallen to 139 percent under the two-tiered system.[77] The three western provinces have all rejected the notion of a two-tiered system, suggesting, perhaps ironically, that it would undermine the federal nature of Canada.

Courchene has estimated recently that this two-tier approach would have resulted in first-tier equalization payments by the federal treasury of $3.409 billion for 1982–83, almost $2 billion less than would have been paid if the national-average standard had been continued as the touchstone of the equalization formula.[78] With a 33-1/3 percent contribution ratio for the second tier, the western provinces would have contributed $2.4117 billion.

The two tiers are not independent of each other. A province which has a positive entitlement for the second tier would receive payments only for the portion of such entitlement that exceeds any negative entitlement associated with the first tier.[79] Thus, for 1982–83, Ontario would have a second-tier entitlement of $1.119 billion, but with a negative entitlement for the first tier of $0.7224 billion, its net entitlement would be $0.3895 billion.[80]

Courchene sets forth several advantages for the proposed two-tier system. First, it would address the funding inequity inherent in the old equalization formula whereby the source of the escalation in equalization payments differed geographically from the source of the revenues Ottawa needed to cover the increased payments. That is, the funding of equalization is more in line with the "ability to pay."[81] Because the second tier, in effect, provides for a direct transfer of net fiscal benefits

from "have" provinces to "have-not" provinces, the two-tier system is seen as being more consistent with the efficiency arguments for equalization than a "representative national average system" approach. Moreover, as the two-tier system would simply transfer existing revenues across jurisdictions, rather than require new revenues to be raised to fund equalization, the two-tier system is seen as leading to a smaller overall government sector. As well, there would be a considerable saving for the federal government, almost $2 billion in the example year of 1982–83.

The Federal Republic of Germany has a form of two-tier equalization, with the first tier coming from an earmarked shared tax and the second tier being an interstate revenue-sharing pool.[82]

Professor John Helliwell has proposed a substitution for the equalization scheme with an interprovincial revenue-sharing system with common tax and benefit rates; but interprovincial negotiations would set the rate at which revenues would be redistributed.[83] The upper limit would thus be determined by the generosity of the producing provinces. Helliwell and Scott propose that each province contribute 25 percent of its standardized total revenues to the common pool to be shared.[84]

Walter Gainer and Thomas Powrie[85] would treat the flow of resource rents to a government in the same manner as if it accrued to an individual or a company. Section 125 of the *Constitution Act, 1867* prohibits intergovernmental taxation, necessitating a voluntarily negotiated federal-provincial revenue-sharing agreement. This proposal is also dependent upon periodic, voluntarily agreed-to payments by the producing provinces. Moreover, with both the Energy Pricing and Taxation Agreement (EPTA) of September 1, 1981, and the Western Accord of March 28, 1985, between Alberta and the federal government, whereby a revenue-sharing arrangement was finalized outside the context of equalization payments, this idea was passed by, at least for the present.

The Economic Council of Canada in *Financing Confederation*[86] saw provincial ownership and constitutional authority over natural resources as meaning energy rents should largely remain at the provincial level — and perhaps the Council did not view equalization as meaning more than a federal obligation to ensure funding a basic level of provincial public services. The Council did, however, suggest that for formula purposes, equalized energy rents passed on in benefits to provincial residents should be subject to a notional federal tax.[87] Presumably the federal government would get the funds via federal-provincial agreement. The Economic Council of Canada's approach would ignore those monies isolated in a "heritage fund" until the benefits therefrom were received by the residents of the province.

In its 1980 Budget Paper A, "Equalization and Fiscal Disparities in Canada," the Ontario government made several proposals. Scenario II is a variation of the Courchene and Copplestone formulation. In this

second tier, the financing would be obtained by provinces above the national average on a per capita basis contributing 25 percent of their resource surpluses to a pool. Provinces below the per capita national average would receive 25 percent of their resource deficiencies from the pool. However, Ontario proposed as well not to subtract its positive entitlement thereunder from its overall negative entitlement under the non-resource revenue sources and, undoubtedly, many would take exception to this approach.

The Means to Achieve Fiscal Equity

On a basis of both efficiency and fiscal equity, but primarily for the latter reason, which is sufficient in itself, there should be more equalization. A greater redistribution of provincial income could bring all provinces closer to the same approximate standard of fiscal capacity.

If constitutional change is necessary, a provision could, in theory, be introduced allowing the federal government to tax provincial property (in effect, resource rents), modifying section 125 of the *Constitution Act, 1982* to the extent necessary to redistribute provincial fiscal capacity to meet the mandate of subsection 36(2). Even to contemplate such a change seems to be politically naïve. Such a proposal is also repugnant to the concept of provincial ownership of property as seen by many Canadians. However, having said that, one should also remember that such a proposal would result in more revenue for most provinces.

The federal government could, of course, redistribute some part of energy rents through federally regulated price ceilings under the trade and commerce power. However, price de-regulation for oil makes sense in economic terms, but federal quasi-royalty taxes, like the petroleum and gas revenue tax, are seen as inappropriate, given provincial ownership of resources and the fact that constitutional authority rests with the province to manage its resources.[88] Therefore, federal price regulation and federal quasi-royalty taxes are not suitable or desirable mechanisms for the redistribution of resource revenues or to achieve the objective of greater equalization of provincial fiscal capacity. Even more repugnant to many Canadians might be any proposal to modify section 125 to allow the federal government to tax provincial property, even for the limited purpose of funding equalization.

Constitutional Amendment

A more acceptable approach would be for the provinces to agree constitutionally to an obligation to fund part of equalization. The "two-tier" proposals of Courchene and Copplestone, the 1980 Ontario Budget proposals and the suggestion of an interprovincial revenue-sharing system by Helliwell and Scott, all would favour this type of approach. However, all apparently would be based upon federal-provincial negotia-

tion every five years in the context of renegotiation of the equalization program. It is unrealistic to think that this is feasible, given the political forces often compelling some provinces to act in their narrow self-interest. Certainly, the details and mechanics of equalization require periodic federal-provincial agreement. However, the core value of fiscal equity, as this paper has argued, is a cornerstone and fundamental aspect of the basic institutional structure of the nation. The enshrinement of the value is seen in the articulation of principles in section 36 of the *Constitution Act, 1982*, but the means to carry out the principles are lacking. The provinces must be constitutionally obliged to contribute some part of their excess fiscal capacity to a redistribution pool for equalization purposes, given the unique nature of resource revenues.

Accordingly, this paper recommends that federal-provincial negotiations ensue to consider amending subsection 36(2) of the *Constitution Act, 1982* to provide that provincial legislatures and governments, as well as Parliament and the government of Canada, "are committed to the principle of making equalization payments." In his appearance before the parliamentary task force on federal-provincial fiscal arrangements, the then Minister of Finance Allan MacEachen viewed the concept of a two-tier system as consistent with the principle of equalization as expressed in the initial draft of what is now subsection 36(2) of the *Constitution Act, 1982*; however, the initial draft made reference to both levels of government, whereas the final version obligates only Parliament and the federal government.[89] Accordingly, subsection 36(2) can be interpreted as excluding an interprovincial revenue-sharing pool.[90] A second proposal is that a new provision, to be enacted as subsection 36(3), be negotiated between the federal and provincial governments to provide the broad framework for the implementation of an equalization program in order to achieve equitable fiscal federalism as now contemplated by the principles enunciated in subsections 36(1) and (2). The amended subsection 36(2) and new subsection (3) could provide a broad framework of principle and commitment plus the essential specifics of provincial obligation. This could possibly take the form of a two-tier provision, with the federal government funding the first tier entitlements to equalization.

This approach would result in a return to a national average per capita fiscal capacity standard and would allow some portion of natural resource revenues to be redistributed as equalization to bring "have-not" provinces closer to the national average standard than at present. Natural resources revenues would influence the magnitude of equalization payments. The second tier of equalization would be funded by resource-rich producer provinces.

There are various alternatives by which the second tier entitlements to equalization could be structured, in particular, by using the Courchene-Copplestone model, as previously discussed. An additional possible approach would be for provinces above the per capita national average in

fiscal capacity to contribute monies equal to a percentage, say 25 percent of their excess fiscal capacity, or to contribute monies to a second-tier pool equal to 25 percent of their resource revenue sources' surplus (computed by determining a province's per capita resource revenue as compared to the national average per capita resource revenue), whichever is the lesser amount. Provinces below the per capita national average in fiscal capacity would receive per capita payments from this pool via the federal treasury, the payments going to the province with the greatest deficiency until its deficiency equals that of the province with the next greatest fiscal deficiency, with payments then going equally to those two provinces until they rise in fiscal capacity to the province with the next greatest fiscal deficiency, and so on.

Such an approach would mean that only the relatively minor details of the equalization program would need to be renegotiated and reformulated every five years. The commitments to basic principles and the basic funding mechanism would be set forth clearly in the constitutional framework and would serve to bring the nation closer to truly equitable fiscal federalism.

Nova Scotia Agreement Example

Another approach is exemplified by the Canada–Nova Scotia Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing of March 2, 1982. *The Canada–Nova Scotia Oil and Gas Agreement Act*[91] gives legislative effect to the Canada–Nova Scotia Agreement. It provides a useful example of an alternative approach to resource rent sharing.

Under the Canada–Nova Scotia revenue-sharing arrangement of March 2, 1982, the Nova Scotia government receives 100 percent of offshore revenues so long as its per capita fiscal capacity, including its share of offshore revenues, does not exceed 110 percent of the national average per capita fiscal capacity (plus two percentage points for every percentage point by which Nova Scotia's annual average unemployment rate exceeds the national average annual employment rate).[92] There are then three *tranches* of sharing. Nova Scotia receives 80 percent of incremental revenues as its per capita fiscal capacity climbs from 110 percent of the national average to 120 percent.[93] In the second *tranche* Nova Scotia receives 50 percent of incremental revenues while its per capita fiscal capacity is between 120 and 130 percent of the national average. When its fiscal capacity exceeds 130 percent, the percentage is limited further, with an overall capping upon receipts of incremental revenues should it rise above 140 percent of the national average.

The above approach has several advantages, most notably that it works like a progressive tax rate, so that there is a large element of

vertical equity present. This approach, extended to rents from resources within provincial boundaries, would result in much greater equalization where significant disparities in fiscal capacity arise, as seen in the past decade of the energy crisis. On the other hand, relatively slight increases in fiscal capacity due to resource rents beyond the national average (10 percent in the offshore Nova Scotia case) would not trigger the redistribution mechanism. Finally, given the fundamental distinction between which government has ownership and control as between provincial lands and offshore Canada lands, it would be best to have a redistribution scheme for provincial resource rents which always allows the province a significant percentage, say 50 percent, of incremental revenues. The offshore Nova Scotia approach, without the capping feature, affords a useful model. Adapting it to onshore provincial resource rents, no monies would be payable by a producing province in respect of resource rents toward a second tier of equalization payments until the paying province's per capita fiscal capacity rose above 110 percent of the national average per capita fiscal capacity, when there would be some payments toward equalization as provincial per capita fiscal capacity continued to rise. Such payments would be at progressively higher rates as fiscal capacity continued to rise and exceeded certain levels above the national average, with the top rate of 50 percent of incremental energy rents being applicable once provincial per capita fiscal capacity exceeded 130 percent of national average per capita fiscal capacity.

Given the intent of the federal government to treat the offshore as though it is onshore and within the adjacent coastal province, as seen in the Atlantic Accord (and as announced in respect of the intended modification of the Canada–Nova Scotia Agreement so that Nova Scotia will be put in the same position as that of Newfoundland through the Atlantic Accord), the redistribution scheme suggested above should be made applicable to the offshore as well as the onshore in respect of resource revenues. That is, given the premise of the Atlantic Accord, to not distinguish between the onshore and offshore, it follows that any redistribution of provincial resource rents through a two-tiered equalization mechanism, should apply in the same manner to the offshore as to the onshore.

In offering this approach for consideration, it is also suggested that all of a province's resource revenues enter the regular equalization formula, in the same manner as its revenues from other revenue sources. There should not be special, bilaterally agreed-to equalization offset payments, which are the subject of severe criticism in respect of the Nova Scotia Agreement,[94] and in respect of the Atlantic Accord. The equalization program should apply in the same manner to all provinces.

With a two-tier system for equalization constitutionally entrenched, as prosperity between regions fluctuates over time, there would be an

adjustment mechanism in place, with constitutional rights and obligations. The country can ill afford not to have an appropriate sharing mechanism to deal with present imbalances in fiscal capacity. Of even greater importance is to have a mechanism in place in respect of any future energy crisis and renewed escalation of energy rents, particularly if the federal government contemplates giving coastal provinces constitutional authority over the adjacent continental shelf, through constitutional entrenchment of the Atlantic Accord and any later accords with other coastal provinces with respect to the offshore.

All Provincial Revenue Sources to be Considered

Given the principles set forth in section 36, the obligation of Parliament and the government of Canada to pay equalization should be based on a system that considers all provincial revenue sources, yet measures fiscal capacity as against the standard of national average per capita fiscal capacity. However, given that this could result in an excessive financial obligation upon Parliament and the federal government, due to equalization stemming from resource rents, there should be an overall ceiling placed upon the obligation of Parliament and the federal government to make "first-tier" payments of equalization over the previous year's payments, say (as at present) to the extent of the annual percentage increase in gross national product. Admittedly, limiting the increase in equalization payments to the percentage increase in the GNP, a practice that began with the 1982–1987 fiscal arrangements, constitutes a departure from the equalization principle of fiscal equity. However, a producing province would be obliged to pay into the second tier of equalization in all events, even if Parliament and the government of Canada were able to bring "have-not" provinces up to the national average in per capita fiscal capacity by payments under the first tier within the increase-in-GNP ceiling. In such an event, the payment by the producing province into the second tier of equalization would, in effect, go toward reducing the payment otherwise required to be made by the federal government. In this situation, the equalization payment, while within the increase-in-GNP constraint, would necessarily be a resource-rent-created equalization payment and, accordingly, the redistribution from the province with excess fiscal capacity should still take place.

To date, the position of the western producing provinces and Newfoundland has been to oppose vehemently any suggestion that any part of their resource revenues should be used toward making up equalization payments. However, if the constitutional changes in respect of section 36 of the *Constitution Act, 1982* were blended with a wholesale revamping of the basic institutional structure of the nation — as part of a grander scheme of nation- and economy-building, such an approach might be

seen as both desirable and possible. In the context of an overall new "National Policy," equitable fiscal federalism would be seen as one key element.

Hydro-electric Power

While it has been the revenues from petroleum and natural gas that have skewered the equalization system over the past decade, it is emphasized that the proposals set forth relate, generally, not only to energy rents, but to all natural resource rents. To consider only petroleum and natural gas would be discriminatory and unfair; all resource revenues must be taken into account. Included, as well, in the consideration of provincial resource revenue sources, should be foregone rents in respect of hydro-electric power. Quebec and Manitoba both produce immense quantities of hydro-electric power which is significantly under-priced for their residents, with the result, in effect, that there is no sharing of the economic rents from this resource through the equalization program. Moreover, both provinces have substantially larger entitlements to equalization than would be the case if these revenue sources were properly taken into account. Any national sharing scheme through the equalization program must take into account sharing and non-sharing through present government activities beyond the formal equalization program. The Economic Council of Canada estimated that if all resources revenues were to be fully equalized, including hydro rents, equalization payments to Manitoba and Quebec would be reduced by about one-third, while payments to Prince Edward Island and Nova Scotia would be increased by 13 to 15 percent.[95]

In its 1982 report, *Financing Confederation*, the Economic Council of Canada estimated that for 1980–81, with all resource revenues, except hydro rents, taken into account for equalization purposes and without any capping provision in effect, equalization payments would almost double those under the existing program.[96] However, with the constraint imposed by equalization payments not growing at a rate higher than the rate of growth of GNP, payments for 1982–83 and 1986–87 were projected to be only about 8 percent higher than under the current program.[97] With the inclusion of hydro rents, the increase would be even less. The inclusion of hydro rents would reduce equalization payments otherwise payable because it would result in a more even distribution of resource revenues across Canada than is reflected under the existing equalization formula.

Courchene, Helliwell and Scott, the Economic Council of Canada and generally all those advocating a form of interprovincial revenue-sharing proposal argue that potential as well as actual resource revenues and rents should be calculated. All argue for the inclusion of foregone hydro

rents in equalization determination, recognizing that the quantification of such rents is somewhat imprecise.[98] It may be that 25 years from now, the major source of resource revenues will be hydro-electric power rents rather than fossil fuel rents.

National Energy Policy

The proposals of this paper have been advanced with an objective of fiscal equity: bringing all provinces closer toward the national average in per capita fiscal capacity. As already cited, the Rowell-Sirois Report emphasized that such proposals would result in the concrete expression of the "conception of a federal system which will both preserve a healthy local autonomy and build a stronger and more unified nation."

Moreover, an improved, comprehensive revenue-sharing mechanism for resource revenues would serve well the objectives of both national economic policy and national energy policy. With respect to the national economy, the tremendous shocks generated by the energy crises of 1973–81 would have been diffused relatively harmlessly if a comprehensive equalization scheme had been in place and if natural resources had been priced at their economic rents with equalization being financed in part out of resource revenues instead of general taxation. By pricing domestic resources at the world market level, the rents generated by rising world prices would have been automatically recycled. The adversely affected purchasing power as well as the impacts of inflation and unemployment in respect of consuming provinces, would have been alleviated. Fiscally induced migration would also have been attenuated. Federal-provincial confrontations would have been avoided and unilateral actions by the federal government through regulated price ceilings and special energy taxes, which introduced inefficiencies and transactional costs, would have been rendered unnecessary.

The proposed constitutional changes could be done within the context of the dismantling of the National Energy Program (NEP) by the Western Accord of March 28, 1985, the federal government and the three western provinces. The Western Accord (to be discussed infra) will serve both to further the national public policy objective of providing greater energy security and to stimulate the energy economy of the western producing provinces. However, NEP was introduced by the federal government with its October 28, 1980 budget in large part because the federal income tax system and price regulated ceilings were inappropriate mechanisms to effect revenue sharing. NEP, as seen at present, resulted in over-regulation, inadequate producer netbacks and discrimination (both against provincial lands in favour of Canada lands and against foreign ownership, through the operation of the petroleum incentive payment system). However, there cannot be a coherent, stable, generally acceptable and effective domestic energy policy for Canada's long-term needs

without resolution of the issue of the sharing of energy rents between the federal and provincial governments within a clearly established set of principles. An appropriate sharing mechanism, together with an appropriate and viable management framework, are necessary pre-conditions to a national energy policy.

Economic Council of Canada Proposals

The Economic Council of Canada's recently published *Connections: An Energy Strategy for the Future* emphasizes that the cornerstone of energy policy for the next 10 to 15 years should be to allow domestic energy prices to reflect economic values to a much greater extent,[99] so that energy policy can make the maximum contribution possible toward the primary objective of raising the income of Canadians. The Council sees the economic objectives of growth, development and the efficient management of resources as the primary concerns in energy policy before the 1973 OPEC crisis, but not over the past 12 years when the two OPEC price shocks made economic stabilization and the sharing of energy revenues the paramount issues.[100] The Council considers that a first requirement of a new energy policy is the replacement of the present cumbersome regulatory regime of detailed sets of rules, regulations and pricing formulae by a "strategy aimed at facilitating flexible adjustment of prices to changing conditions in the market place."[101]

The proposals of the Economic Council of Canada for the reformulation of a national energy policy have considerable appeal. However, the resolution of the issue of economic efficiency and development means that there should also be an appropriate mechanism to deal with the problem of regional fiscal disparities within Canada.

The Council sees two principal elements in respect of federal-provincial fiscal relations in relation to energy policy. The first concerns equity among Canadians with respect to provincial taxation and the provision of services by their principal governments, which are handled through the equalization program, the subject of this paper. However, the Council identifies the second as "the participation of all Canadians in financing the cost of the nation;"[102] that is, the costs of federal services and activities must be distributed fairly among Canadians on the basis of ability to pay.[103]

The Council recommends that resource rents should be collected by the owner, the province, but that the federal government "should have access to an agreed share of these rents, regardless of the policies of the provincial governments with respect to their collection and distribution."[104] However, it views an appropriate rent-sharing arrangement as a longer-term arrangement after protracted negotiations, whereas improvements in resource-management can begin immediately.[105]

The federal government entered into a Western Accord with Alberta,

British Columbia and Saskatchewan March 28, 1985, effectively dismantling the National Energy Program and adopting virtually all of the proposals recommended by the Economic Council of Canada as to the management framework for petroleum and natural gas. Thus, the Western Accord will result in the deregulation of the price of oil as of June 1, 1985, and it is intended that natural gas pricing will be made market-sensitive in the near future. As well, the plethora of special federal taxes, incentive grants and tax-offset payments will all be phased out. By the Western Accord the federal government will move the petroleum and natural gas sector of the economy from an excessively regulated and costly "administered system," to a "market system."

However, the Western Accord implicitly denies the need for an equitable revenue-sharing mechanism in respect of resources rents. The Western Accord will reduce the federal government's revenues simply to those realized through income taxes. The problems suggested by this paper, and by the Economic Council of Canada, in respect of federal-provincial fiscal relations in relation to energy policy, are not addressed in the Western Accord. The matter of equalization is not mentioned. Thus, while the Western Accord undoubtedly has considerable merit in serving to restore market efficiencies to the energy sector of the economy, it omits mention of the most fundamental public policy issues in respect of energy over the past 12 years, the question of equitable rent-sharing and an appropriate mechanism to effect that objective.

While the low-cost oil resources of the Western Sedimentary Basin are largely developed, there are extensive low-cost natural gas reserves and higher-cost petroleum and natural gas reserves in both the three western provinces, and on Canada lands (Yukon, the Northwest Territories and the offshore continental shelf), which can still be produced at costs lower than the world price. As well, the world price for oil may rise again and at a pace higher than the rate of inflation. In the long term, it is only Saudi Arabia, Iran and Iraq in the non-Soviet-controlled world that will have sizeable surplus oil reserves available for export. The stability and political orientation of these countries, together with their capacity as the core of the OPEC cartel, will greatly influence the future world price of oil, as well as security of supply in the free world. As Canada is a price-taker in the world market for oil, the future presents significant risks and opportunities for the development of Canadian petroleum and natural gas reserves. The national objective of security of supply in Canada through the development of domestic reserves of petroleum and natural gas, together with the matter of the export of surplus, will depend largely upon the issue of price which, in turn, necessitates a consideration of revenue sharing as between the two levels of government and industry. Maximizing the welfare of Canadians depends upon the coincidental pricing of natural resources so that their prices equal their economic

rents (their marginal contributions to gross national product) and the sharing of those rents in an equitable manner.

Advantages for the Producing Provinces

A resolution of the revenue-sharing issue on an equitable basis should result in a situation whereby the overall constitutional scheme in respect of resources is made more workable than at present. The producing provinces would have the freedom to act as owners and as stewards and managers of their resources, as contemplated by the *Constitution Act, 1867* (sections 109, 92(5), (13), (16) and 92A), limited only by the traditional division of powers which gives to Parliament constitutional authority in respect of trade and commerce, interprovincial works and undertakings, and through the declaratory power (subsections 91(2), (29) and 92(10)(a) and (c)), together with the residual power and power to deal with emergencies, through the "peace, order and good government" clause. Resource rents would be collected by the provincial government owners under the collection mechanisms they have chosen. The provinces' only commitment under an amended section 36 of the *Constitution Act, 1982*, would be to transfer the agreed share of revenues to the federal government as the intermediary for a second tier of equalization to "have-not" provinces.

Moreover, the producer provinces would regain effective responsibility for the exploitation and development of natural resources. Federal price regulation by way of underpricing would not be seen as necessary to redistribute energy rents and the province would collect rents through bonus bids, production royalties and lease rentals on provincially-owned minerals or production taxes on freehold interests. The provincial governments would be responsible for funding resource activity on their lands where rents are available. Overall, there would be more efficient resource management. Federal quasi-royalty taxes, like the petroleum and gas revenue tax, or the incremental oil revenue tax, would not be necessary. Ideally, both the federal and provincial governments would modify their rent collection tools for them to apply to a net revenue base, with the rates of taxation and rates of royalty being set competitively, but with the damage to private economic incentives being considerably reduced.

This paper deals with the problems of sharing resource rents by incorporating a sharing mechanism to facilitate equalization through section 36 of the *Constitution Act, 1982*. If a fair and suitable mechanism is put in place through section 36, such as that in the Canada–Nova Scotia Agreement,[106] it is not foreseen that the federal government should tax resource revenues in the producing province except through the general income tax payable by the industry.

The report of the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements estimated the cost of equalizing 30 percent of all natural resource revenues for 1986–87 to be $3,622.6 million, this amount being made up of $65 million in respect of Saskatchewan, $3,463.1 million in respect of Alberta and $94.5 million in respect of British Columbia.[107] The estimated revenues to the federal government for the fiscal year ending March 31, 1983, from the petroleum and gas revenue tax, natural gas and gas liquids tax and oil export charge, totals $3,476 million.[108] Increased equalization payments, through contributions under a two-tier system by the producer provinces, could be balanced off approximately by the withdrawal by the federal government of its producer-related special excise taxes.

As of this date, there is great uncertainty in respect of the future world price of oil. It is suggested that in the long term the price may well rise again, possibly dramatically, and that this necessitates putting in place now a suitable equalization formula and mechanism in pursuit of equitable fiscal federalism.

On the other hand, it is quite possible that in the short term the price of oil may fall dramatically, given OPEC's apparent inability to control supply. This phenomenon may well suggest government measures of another form, also in pursuit of equitable fiscal federalism. Either as a measure together with the United States or, preferably, as part of a broader energy agreement reached with the Organization of Economic Cooperation and Development countries, a relatively high minimum domestic price might be set for oil. This could be accompanied by a tax upon imported oil so as to ensure a minimum import price equal to the minimum domestic price. This would give needed financial security to the international investment community and afford western economies the price baseline by which security of supply, through increased self-sufficiency, could be reached. Within this minimum price many Canadian high-cost energy megaprojects could proceed on a basis of price certainty. Longer-term energy export contracts could then be obtained as well, with advantage to Canada. Overall, Canada can gain immensely through exploiting its comparative advantage in terms of trade in the energy sector. This would particularly benefit the western producing provinces of Canada as well as those provinces receiving resource revenues from adjacent offshore development. If this approach were taken, it might well be (if OPEC prices fell below the minimum domestic price for oil) that residents of the consuming provinces would once again (as under the national oil policy of 1961) pay higher than world prices for domestic oil, in the interest of national security of supply and fostering regional growth.

Other national objectives might also be addressed — in particular, for example, greater free trade with the United States — when the proposals for constitutional reform suggested in this paper are considered.

Finally, such a basic restructuring as proposed could be seen as one part of meaningful, rational trade-offs by all Canadians for the overall national good in several important areas of public policy concerned with the institutional structure of the nation.

Conclusion

The core value of equitable fiscal federalism is fundamental to the concept of Canada as a federal state, and this has been so since Confederation. The enshrinement of this value is seen in section 36 of the *Constitution Act, 1982*. The principles enunciated therein can be made more workable only through constitutional amendment. Subsection 36(2) of the *Constitution Act, 1982* should be amended to bind the provincial legislatures and governments, as well as Parliament and the government of Canada, to the principle of contributing toward equalization payments. As well, a new provision should be negotiated and enacted, as subsection 36(3), providing the basis of a mechanism for the equitable sharing and redistribution of resource rents. These constitutional changes would serve the objective of achieving equitable fiscal federalism and, consequently, a stronger and more united Canada.

Notes

This study was completed in May 1985. The author acknowledges, with appreciation, the valuable assistance of Terrance Marshall, a 1982 graduate of Osgoode Hall Law School of York University, in the preparation of this paper.

1. Economic Council of Canada, *Connections: An Energy Strategy for the Future* (Ottawa: Minister of Supply and Services Canada, 1985) at 125.
2. See, generally, J.R. Pritchard with Jamie Benedickson, "Securing the Canadian Economic Union: Federalism and Internal Barriers to Trade" in M.J. Trebilcock, J.R.S. Pritchard, T.J. Courchene and J. Whalley (eds.), *Federalism and the Canadian Economic Union* (Toronto: Ontario Economic Council, 1983).
3. 30 & 31 Vict., c. 3, as amended, 1982, c. 11 (U.K.)
4. Ibid., s. 118.
5. See Wilfrid Eggleston and C.T. Kraft, *Dominion-Provincial Subsidies and Grants*, a study prepared for the Rowell-Sirois Commission on Dominion-Provincial Relations (Ottawa: King's Printer, 1939) at 11, 12.
6. Ibid., at 3.
7. R.S.C. 1970, Appendices, No. 8, s. 25.
8. *Supra*, note 5 at 12.
9. Ibid., at 19.
10. 7 Edw. VII, c. 11 (U.K.)
11. *Supra*, note 5 at 86–88.
12. Canadian Tax Foundation, *The National Finances* (Toronto: The Foundation, 1983): "An analysis of the revenues and expenditures of the Government of Canada 1982–83," Table 10.2, at 180.
13. *Supra*, note 5 at 53.
14. *Report of the Royal Commission on Maritime Claims* (Ottawa: F.A. Acland, 1926) at 19.

15. 20-21 Geo. V, c. 26 (U.K.).
16. *Report of the Royal Commission on Dominion-Provincial Relations*, 3 vols. (Ottawa: King's Printer, 1940), in particular ch. 5, Book II, at 81–86, and 125–30.
17. Ibid., at 125.
18. Schedule B to the *Canada Act, 1982* (U.K.), 1982, c. 11.
19. The standard references are Douglas H. Clark, *Fiscal Need and Revenue Equalization Grants* (Toronto: Canadian Tax Foundation, 1969), and Thomas J. Courchene, *Equalization Payments: Past, Present and Future* (Toronto: Ontario Economic Council, 1984).
20. Department of Finance, Federal-Provincial Relations Division, *Provincial Fiscal Equalization Third Estimate 1984–85*, January 8, 1985, Summary Table 1, at 1.
21. In the fiscal year ending March 31, 1981 equalization payments equalled $3,590.4 million, with total federal contributions to the provinces and municipalities equalling $12,621.7 million. Thus, equalization payments represented 28.446 percent of such transfers in that year. *The National Finances*, note 12, Table 10.3, at 183. For the fiscal year ending March 31, 1981, total federal government expenditures were $58.066 billion, equalization payments thus being 6.18 percent of total expenditures. (Using data from *National Finances*, note 12, Table 3.2, at 40).
22. For fiscal 1982–83, revenue estimates of provincial governments in respect of equalization payments as a percentage of gross general revenue were as follows — Newfoundland, 29.1 percent; P.E.I., 31.2 percent; Nova Scotia, 24.5 percent; and New Brunswick, 25.8 percent. For all provinces combined, the percentage was 6.4 percent. Canadian Tax Foundation, *Provincial and Municipal Finances 1983* (Toronto: The Foundation, 1983), Table 3.3, at 59.
23. *Supra*, note 16 at 83.
24. Ibid., at 125.
25. *Supra*, note 16, Book I at 47–52.
26. S.C. 1976–77, c. 10; S.C. 1980–81–82–83, c. 94; S.C. 1984, c. 13 (effective for the period April 1, 1982 to March 31, 1987).
27. Canada, House of Commons, Federal–Provincial Tax Structure Committee, *Proceedings*, September 14–15, 1966 at 15.
28. Canada, Parliamentary Task Force on Federal–Provincial Fiscal Arrangements, *Fiscal Federalism in Canada* (Ottawa, 1981) at 157.
29. T.J. Courchene, "Equalization Report Realistic," *The Financial Post*, October 17, 1981 at 8.
30. John F. Graham, "Equalization and Canadian Federalism" (1982), 2 *Public Finance* at 246, 247.
31. See Part I of the *Federal–Provincial Fiscal Arrangements and Federal Post-secondary Education and Health Contributions Act, 1977*, as amended, section 4.
32. T.J. Courchene, "Equalization Payments and Energy Royalties" in A. Scott (ed.), *Natural Resources Revenues: A Test of Federalism* (Vancouver: University of British Columbia Press, 1975) 74 at 82, Table 3.
33. Net benefit figures for 1980–81 equalization transfers are from D. Sewell and D. Slater, "Canada's Equalization Program," unpublished paper, 1982.
34. *Supra*, note 1 at 127.
35. *Supra*, note 33.
36. The Honourable Frank Miller, "Equalization and Fiscal Disparities in Canada," Budget Paper A (Toronto: Ministry of Treasury and Economics, 1980), *Ontario Budget 1980* at 9.
37. T.J. Courchene and G.H. Copplestone, "Alternative Equalization Programs: Two-Tier Systems," in Richard Bird (ed.), *Fiscal Dimensions of Canadian Federalism* (Toronto: Canadian Tax Foundation, 1980) 8 at 12, 13.
38. S.C. 1974–75–76, c. 65, s. 1.
39. S.C. 1976–77, c. 10.

40. *Supra*, note 36 at 7.
41. S.C. 1981, c. 46.
42. The Honourable Frank Miller, "Renegotiation of Federal–Provincial Fiscal Arrangements: An Ontario Perspective," Budget Paper B (Toronto: Ministry of Treasury and Economics, 1981), *Ontario Budget 1981*.
43. This analysis is adapted from Courchene and Copplestone, *supra*, note 37 at 17, 18, Table 1.
44. Ibid., at 28, Table 2.
45. 1981 federal Budget (Ottawa: Minister of Supply and Services Canada, 1981) at 35–36, 44–45, 51–52.
46. Department of Finance, *Fiscal Arrangements in the Eighties — Proposals of the Government of Canada*, Budget Paper (November 1981) at 18.
47. *Supra*, note 37 at 9.
48. Courchene, *supra*, note 19 at 63, 128–30.
49. T.J. Courchene, "A Market Perspective on Regional Disparities" (1981), 7 *Can. Pub. Pol.* 506 at 513, 517.
50. Economic Council of Canada, *Financing Confederation Today and Tomorrow* (Ottawa: Minister of Supply and Services Canada, 1982) at 26.
51. Ibid., at 36. For commentary, see K.H. Norrie; M.B. Percy; L.S. Wilson; J. Vandercamp; J.T. Bernard; D.M. Cameron; A.R. Dobell; and D.A.L. Auld (1982), 8 *Can. Pub. Pol.* 283–333.
52. John F. Graham, "Fiscal Adjustment in a Federal Country" in *Intergovernmental Fiscal Relationships*, Canadian Tax Paper No. 40 (Toronto: Canadian Tax Foundation, 1964) at 16, 17.
53. *Supra*, note 49 at 516.
54. *Supra*, note 48 at 110, 124–30.
55. Ibid., at 405, 406.
56. Total equalization payments from 1957–58 to 1979–80 were $21.151 billion. *Supra*, note 36, *Ontario Budget 1980*, Budget Paper A at 5. Payments from 1980–81 to 1986–87 are estimated to be about $35 billion. As Ontario represents about 40 percent of the federal income tax base, then income tax payments by Ontario residents toward total equalization will easily exceed $20 billion for the period 1957–58 to 1986–87.
57. *Supra*, note 1 at 4.
58. S.C. 1980–81–82–83, c. 68, as amended by 1980–81–82–83, c. 104 and c. 158.
59. S.C. 1974–75–76, c. 47 as amended, Parts II and III.
60. *Supra*, note 50 at 37.
61. Ibid., at 43, 44.
62. Ibid., at 43.
63. Ibid.
64. Letter of August 23, 1979, from the Honourable Brian Peckford, Premier of Newfoundland, and reply of Prime Minister Joe Clark of September 14, 1979. However, it is to be noted that the United Nations *Convention on the Law of the Sea*, U.N. Document A/CONF. 62/122 of October 7, 1982, does not give ownership of the continental shelf to the adjacent coastal nation. It is merely a sovereign right of exploring and exploiting the natural resources of the continental shelf — Articles 56 and 77. See *Reference Re the Seabed and Subsoil of the Continental Shelf Offshore Newfoundland*, [1984] 1 S.C.R. 86.
65. Address to the Board of Trade, St. John's, Newfoundland, June 14, 1984, numbered statements 10 and 17.
66. The Atlantic Accord not only runs directly counter to the theme of fiscal equity, but also to two other basic themes of Canadian federalism, central to the concept of nationhood since Confederation. First, Confederation was founded, in part, upon the objective of achieving the efficiencies of an economic union through the colonies

coming together. However, by giving to Newfoundland the right to control significantly offshore development, the federal government has allowed the province to introduce preferences that may well result in serious economic distortions.

In particular, industry favours development of the Hibernia oil field by way of a floating mode of production, at least in the first instance, until a cash flow is gained and the precise nature of the reservoir is determined. A floating mode would cost only $2 billion and would be reusable. However, this mode would generate employment primarily in the shipyards of Nova Scotia, New Brunswick and Quebec. Therefore, to capture more employment and economic activity for Newfoundland, the previous government has indicated a preference for a fixed structure of production, one which may necessitate a cost of more than $2.5 billion.

In effect, the federal government has allowed the Newfoundland government to create a distortion in the marketplace and on federal lands for which only Canada has present constitutional authority.

Another theme basic to the constitutional structure of Canada is that matters of national interest rest within the federal sphere of constitutional powers and should be decided by the federal government as determined by Parliament, the institutions responsible and accountable to all Canadians. However, the federal government is now prepared to allow Newfoundland to decide matters within Parliament's present constitutional powers. For example, suppose that the country is able to achieve self-sufficiency in oil and energy security, and the federal government then wishes to export offshore surplus. The Atlantic Accord gives Newfoundland a veto over any such proposal.

Moreover, while the federal government reserves the right to make fundamental decisions (other than as to the *mode* of development) with respect to offshore development until "self-sufficiency" and "security of supply" are attained, if there is a dispute between the governments as to whether these goals have truly been achieved, the deadlock is broken by the vote of the Chief Justice of Newfoundland. Unlike every other federal state in the world that is a parliamentary democracy, Canada now seeks to resolve disputes that the central government may have with a provincial government on a matter within the national government's constitutional sphere of powers, by appointing an arbitrator.

67. *Supra*, note 42, *Ontario Budget 1981*, Budget Paper B at 21.
68. Ibid., Chart 2 at 20.
69. See, generally, Courchene, *supra*, note 19 at 263–80.
70. Indeed, the Ontario government in its budget of 1980, Budget Paper A, *supra*, note 36, referred to "The Emergence of Over-Equalization" at 13.
71. Canada House of Commons, *Debates*, November 30, 1973 at 8311.
72. Ibid.
73. *Supra*, note 20, Summary Table 1 at 1.
74. Courchene, *supra*, note 19 at 386, 387.
75. The Honourable Michael H. Wilson, Minister of Finance, *Economic Statement*, November 8, 1984; the Western Accord, an agreement between the governments of Canada, Alberta, Saskatchewan and British Columbia on oil and gas pricing and taxation, March 28, 1985.
76. *Supra*, note 37.
77. Ibid., at 38, Tables 4 and 41.
78. Courchene, *supra*, note 19 at 235.
79. Ibid., at 237.
80. Ibid.
81. Ibid., at 238, 239.
82. Ibid., at 257–62.
83. Canadian Tax Conference (1979 Conference Report) at 7. See also John F. Helliwell and Anthony Scott, *Canada in Fiscal Conflict: Resources and the West* (Vancouver: Pemberton Securities, 1981).
84. See Courchene, *supra*, note 19 at 245–51.

85. Walter Gainer and Thomas Powrie, "Public Revenues from Canadian Crude Petroleum Production" (1975), 1 *Can. Pub. Pol.* 1 at 9–12. See Courchene, *supra*, note 19 at 251–54.
86. *Supra*, note 50.
87. Ibid. at 46.
88. See, generally, Submission by the Chairman of the Economic Council of Canada to the Senate Standing Committee on Energy and Natural Resources, May 24, 1984.
89. Courchene, *supra*, note 19 at 240.
90. Ibid., at 398.
91. 32–33 Eliz., c. 29, assented to June 29, 1984.
92. Part III, para. 67(1)(a) together with the regulations.
93. Nova Scotia's average annual employment rate, also taken into account in the revenue-sharing formula, is ignored in this discussion, for the sake of simplicity.
94. The Canada–Nova Scotia agreement does not interfere directly with the equalization formula. All of Nova Scotia's resource revenues will enter the regular formula, in the same manner as its revenues from other sources. However, under the separate, bilateral agreement between the federal government and Nova Scotia, special equalization offset payments are to be made to Nova Scotia so as to limit the impact of the general equalization formula upon the province's revenues from equalization. Thus, the province would receive offset payments equal to 90 percent of the value of the reduction in its equalization payments, due to the impact of its resource revenues entering the equalization formula, from the time of commencement of production until the end of the first full fiscal year following. The rate of offset would be reduced by 10 percent in each subsequent year, until the payments were entirely phased out. Thus, Nova Scotia's equalization will be calculated by including only 10 percent of offshore revenues in year one, 20 percent in year two, and so on. Therefore, overall, Nova Scotia's equalization payments will be determined by an entirely separate, more generous formula, one that runs the risk of generating regional tension rather than fostering national unity. Courchene sees the "possibility of a movement of Canada's equalization program away from a formula-based system to a province-specific system" if the offshore agreement were to be adopted generally. See Courchene, *supra*, note 19 at 75–77, 401–3, 406. The Nova Scotia approach has been followed in the Atlantic Accord of February 11, 1985, and indeed, the equalization offset scheme in the accord is more generous to Newfoundland than the one in favour of Nova Scotia under the present Nova Scotia Agreement.
95. *Supra*, note 50 at 50, 51.
96. Ibid., at 51.
97. Ibid., at 49, 51.
98. See Courchene, *supra*, note 19 at 105, 244 and 250.
99. *Supra*, note 1 at 1, 12.
100. Ibid., at 12.
101. Ibid., at 25.
102. Ibid., at 125.
103. Ibid., at 100.
104. Ibid., at 127.
105. Ibid., at 129.
106. But without the special equalization offsets; see *supra*, note 93.
107. *Supra*, note 28, Table VII-3 at 166.
108. *Supra*, note 12, Table 3.3 at 41.

3

The Harmonization of Social Policy

CLAUDE E. FORGET

Introduction

Harmonization, unlike centralization and decentralization, is an idea that is not often used to analyze public affairs in Canada. Yet it is not enough to describe certain areas of government responsibility as either "centralized" or "decentralized," for these concepts give only a static snapshot of the distribution of powers. Harmonization, on the other hand, attempts to describe how these powers are used. Harmonization is more a movement than a fixed state of affairs, and therefore it describes a dynamic rather than a static property of a system of intergovernmental relations.

The idea of harmonization is of a different order than the discussion of centralization or decentralization. In addition to the distinction made above, the following should also be mentioned. Even if the distribution of government responsibilities among various levels of government were extremely detailed and accurate and even if it were considered "ideal" or "perfect" in some respects, there would still be a need for harmonization. That is because any kind of distribution of powers tends to become fragmented and compartmentalized. There are very few matters that can be grouped under a single constitutional heading and, even if the constitution were rewritten as simply as possible, it would still have to reflect the way in which reality is divided into the issues that appear to us today to be most important. Such a division would still be arbitrary and with time would inevitably become even more so. There are also interdependencies that must be taken into account. Discussions of the right degree of centralization or decentralization are based on a fragmented view of reality — of a piecemeal analysis of government responsibilities — and

those discussions in turn feed and perpetuate that view. A consideration of the harmonization of government policies, on the other hand, is based on the analysis of the interactions involved in the exercise of a number of government responsibilities, and encourages a global perspective of government policies.

There is a third important feature of harmonization: it is a logical category that is essentially distinct from the "centralization-decentralization" category. The concept most directly opposed to harmonization is that of non-coherence or non-compatibility. Ideally the purpose of harmonization is to allow two different objectives to be achieved at the same time. To harmonize policies does not mean to reduce them to a single policy and make them identical. We shall see in this study that consistency has often been the enemy of harmonization because, in sacrificing diversity to an objective that is considered important, one often, without wishing to, sacrifices other objectives that are every bit as important. The harmonization of policies is necessary within a single government, and it is clear in this context that harmonization is not effected by subordinating all departments to a single one, but rather by searching for accommodations and compromise. For example, governments attempt to achieve economic growth and social justice at the same time and as a consequence must adjust their economic and social policies to attain each of these goals to the greatest degree possible. Such adjustments are a good illustration of the concept of harmonization.

In federal-provincial relations, the concept of harmonization above all starts from the assumption that there is a degree of pluralism in the social philosophies of the various provinces and the federal government; there would of course be no need to harmonize social policies based on identical objectives. Pluralism is essential for a proper understanding of federal-provincial institutions. Moreover, the idea of policy harmonization also reminds us that many different kinds of social measures are intended for the same public and must therefore — to a degree that remains to be determined and by means that are specifically considered in this study — take each other into account. This study makes no a priori distinction between what might be called horizontal harmonization (that is, between provinces) and vertical harmonization (between the federal government and one or more provinces). We are interested in both.

In this study, the expression "social policies" means what it usually means; in other words it is a vague and broad concept. In principle, it includes everything that has to do with health and social services, as well as all programs aimed at the income security of individuals and families and even all government activities that create rights to benefits in cash or in kind. Thus the goal of income redistribution or the opportunities provided by programs to facilitate access to housing, legal services or education allow us to classify such programs as social programs.

Because of the obvious limitations on time and resources, most illustrations, and perhaps even conclusions, refer to social policies dealing with health, social services and income security benefits.

Our starting point is the fact that the federal and provincial governments are deeply involved in social policies. This has long been the case and will in all likelihood continue to be so. From here it is only a short step to the following question: has the active simultaneous presence of two levels of government in the same vast field of intervention caused problems that are likely to have adverse effects on the Canadian economy, or on the success of the social policies themselves?

It is not easy to do justice to that question. To what degree are social policies in Canada harmonized, by what methods and with what degree of success? It is not a matter of passing judgment on current social policies in Canada, but rather on whether there is harmonization among the social policies and between these policies and economic policies — whatever their intrinsic merits. Nearly all studies of social policies attempt to evaluate them according to extrinsic criteria, that is, according to what characteristics such policies *ought* to possess. Because our goal is different, we cannot base our own observations on these studies. Moreover, the official documents made available to us very rarely consider policy harmonization.

This study comprises five sections, each of which discusses a distinct strategy used in the past to offset the lack of harmonization. The first section evaluates the key role played by the federal spending power, particularly in relation to social policy. This power has been used to coordinate the timing of provincial action and also to impose "national standards." Our purpose is to determine as carefully as possible which factors accounted for the federal government's success in the past and also the factors that may influence and even limit the success of any future efforts.

The second section is a briefer consideration of a radical strategy used (or proposed) in the past because of the lack of harmonization among provincial policies, namely constitutional amendment. With hindsight, one can see that such solutions made it possible to solve a number of problems, but that they also created new ones. A constitutional amending formula giving the provinces control over social matters was never adopted, but the concept gave rise to some new perspectives.

The third section describes a strategy for harmonization by consensus or by formulas similar to consensus. The technique is not used very much for a number of reasons, particularly the lack of any constitutional basis to give legal effect to those agreements and endow them with some stability.

The fourth section assesses the significance of the failure to coordinate and harmonize the most ambitious federal and provincial effort ever attempted in the field of social policy: the social security review from

1973 to 1977. This was a planned and coordinated harmonization effort which, though not a total waste of time, certainly failed in its main purpose.

Finally, the fifth section presents the conclusions that stem from our overview of harmonization mechanisms in the field of social policy.

The Spending Power and National Standards

The evolution of social policy in the developed countries of the West demonstrates that sovereign countries located close to one another and sharing the same civilization and a great many social and political values, as well as similar living standards, have all adopted social policies that have many points in common. Ideas and people travel readily in our era and, whether we like it or not, the result is similar institutions, taxation systems and social security. Without any special effort to establish it, a degree of implicit harmonization in social policy is found from one country to the next.

However, this international harmonization is far from perfect. Unless two countries have signed a specific treaty, the citizens of one country do not have access to social security benefits of a neighbouring country, even if they take up residence there, and if they change nationality, the retirement benefits they have acquired under their country of origin's pension plan may be lost.

In a federation, harmonization requirements are greater. In Canada the federal government has made itself the interpreter of these requirements by a variety of methods. It is these methods that we will be describing and attempting to evaluate in this part of the study.

The federal government's involvement in social policy takes two main forms. On the one hand, Ottawa on its own has directly designed and administered a number of social programs, such as Old Age Security Pensions from 1951. It would be going too far to speak of harmonization in connection with these programs. What is involved is instead uniformity, because the same program is applied uniformly across the country. Ottawa has also intervened in a number of other programs in a cost-sharing arrangement with the provinces responsible for administering the programs. It is in connection with this second category of action that it is possible to speak of a harmonization role for the federal government.

Ottawa has played this role in many ways. Thus, federal financial participation has profoundly affected the rate at which new programs are introduced. Moreover, as a condition for providing funds, Ottawa has attempted, sometimes successfully, to narrow the scope of differences in provincially provided services by means of a definition of new mandatory standards.

The impressive results of the federal government's intervention in those areas in which the Constitution assigns legislative responsibility to

the provinces is based on the exercise of its spending power. This authority was used to harmonize provincial social policies but not to make them identical or to centralize the management of these policies, because there are limits on the power to spend. It would be useful to look into the nature of these limits because the conditions under which spending authority will be exercised in the future are more likely than ever to test these limits.

The Spread of Innovations

Except for unemployment insurance in 1940, all significant social policies in Canada were instituted after 1944. From 1944 to 1973, Canada underwent rapid economic growth, interrupted only by mild recessions. Prosperity and the resulting feeling of economic well-being were fertile ground for the development of an ideal of social justice at a time when social policies abroad (especially in Europe) provided a concrete demonstration of the feasibility of the various programs which represented that ideal.

Thus even though the federal government had played no part in the social field, it gradually developed all kinds of social programs. The concentration of tax revenues in Ottawa as a result of the war made the federal government a convenient and powerful instrument for carrying out the programs of the social reformers. But the fact that this development took place primarily at the instigation of the federal government rather than the provinces is a historical accident that is not important in relation to the phenomenon itself: the almost explosive development of social programs would have taken place no matter what the political structure of the country. However, such social programs would almost certainly have taken a very different form.[1]

When government policies are under discussion — in social matters as well as others — it is almost always impossible to identify clearly the original source of an idea. Many ideas circulate on a great many questions both within and outside of governments. For example, some descriptions of the development of social policy in Canada go back as far as the work of the House of Commons Special Committee on Social Security in 1943 and 1944. Although the Committee's report did contain the essential components of the current health insurance plan, it also knowingly included a number of the proposals contained in Lord Beveridge's report, which had appeared somewhat earlier in Great Britain. The Committee, moreover, was fortunate in being able to discuss the subject with Lord Beveridge during his visit to North America. Even the sources of Beveridge's ideas may be disputed, because he certainly did not invent the idea of "a national health service": he only adapted the concept.

All of which emphasizes the fact that innovation in government policy

(as in industry) does not lie in the discovery of an idea (and even less in its popularization) but rather in its first successful practical application.

Thus, in state-financed health services, Saskatchewan was clearly the innovator that led to the establishment of the present Canadian system. As early as 1947 Saskatchewan had established a hospital insurance plan. But Saskatchewan was not the only province to experiment with public funding of hospitalization. In 1950 Alberta provided partial financial assistance to municipalities that had established hospital insurance. British Columbia had had its own plan since 1949, and Newfoundland had had a plan of its own from the time of its entry into Confederation. These four public plans differed substantially from one another, and the successful operation of such plans in these four provinces did not appear sufficient to encourage the others.[2]

That is the context in which the influence of the federal government on the spread of innovation in this field must be evaluated: in *four* years, from 1957 to 1961, *all* the provinces adopted the *same* hospital insurance plan. This single plan is substantially the one that had been in operation for ten years in Saskatchewan. This concentrated effort and the speed with which the plan was adopted across the country constitute a major contribution of the federal government to the harmonization of social policy in the provinces.

Beginning in 1968, the same thing was repeated for health insurance. By 1971, all the provinces had adopted the same plan based on an experiment that had been conducted successfully since 1962 — again in Saskatchewan. Here again, before the passage of federal legislation, there appeared to be no trend toward the convergence of programs at the provincial level.

The significance of these facts becomes clearer if they are compared to equivalent data for eleven health service programs not included under hospital insurance or health insurance. In 1982, the "rate" of acceptance of these eleven programs by the ten provinces averaged 64 percent against 100 percent for the two federal-provincial programs. Moreover, while only four years went by from the introduction of federal legislation to acceptance by the last province for each of the two programs introduced, it took an average of fifteen years for the eleven strictly provincial programs, and, in one case, 32 years. Table 3-1 lists these eleven programs with their year of introduction and shows whether they are universal or selective and whether they use deterrent fees.

According to some descriptions of the development of social services policy, it would appear that in an analogous fashion, the adoption of the Canada Assistance Plan (CAP) in 1966 was also preceded by successful provincial plans. According to Leslie Bella, the CAP was preceded in Alberta in particular, by unique social services programs.[3] Bella believes that the programs already established by the various provinces led them to urge Ottawa to adopt the 1966 federal Act. Claude Morin also confirms

that the federal government relied to a great extent on the Boucher Report on social assistance published in 1963, which contained recommendations very similar to the 1966 federal legislation.[4]

These examples suffice, although many others could be cited, since all kinds of "shared-cost" programs had the same effect in other areas of government activity; even in the social field, other programs had similar effects. But the magnitude of the resources employed in the three programs mentioned above illustrates the power of this instrument for policy harmonization. Let us summarize how it was used. Cost sharing was:

- Based on successful experiments over a number of years in at least one province.
- Compatible with a completely autonomous provincial government in terms of capital costs, wage policies and control structures.
- Subject to the requirement that provincial programs be compatible but nevertheless allowed significant variations. Apart from the "national standards," which will be discussed below, the scope of services offered varies considerably from one province to another as do the methods of financing the provincial contribution.
- Used during a period of growing government expenditures to harmonize provincial programs up to a national level.

National Standards

The term "national standards" refers to a small number of common features that must be part of social programs established by the provinces in an area that is harmonized by the federal government. Hospital insurance and health insurance programs include such standards, namely, universality, transferability, comprehensiveness and public administration of programs.

Although national standards are usual, they are not essential. In post-secondary education, for example, there are no national standards. In their absence, federal intervention has the sole effect of stimulating the introduction of a program (health insurance for example) but without any restrictions on the form it must take. The purpose of harmonization is then to coordinate the times at which new programs are introduced, but nothing more. The intent of such restricted harmonization is probably to limit fiscal disparities between provinces or generally to stimulate some beneficial government activity, whatever form it may take.

The CAP provides another concrete example of a program that involves massive financial participation by the federal government but has no national standards. The federal-provincial bargaining that preceded the passage of the federal CAP Act took place at the same time as the discussions that resulted in the opting-out formula, which only Quebec adopted. The premier of Quebec stated during these negotiations that Quebec was opting out of the CAP to avoid having its social

TABLE 3-1 Health and Welfare Canada, Some Complementary Provincial Benefits to the Canadian Health Insurance Program, 1982

Province	Ambulance			Air Ambulance			Dental Care for Children			Medication for the Elderly			Medication for Welfare Recipients			Medication for the Chronically Ill (variable coverage)		
	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF
Newfoundland	—	—	—	50	u	yes	50	s	yes	81	s	yes	50	s	no	65	s	no
Prince Edward Island	72	u	yes	—	—	—	71	u	yes	—	—	—	67	s	no	67	s	yes
Nova Scotia	70	u	yes	—	—	—	74	u	no	74	u	no	—	—	—	76/78	u	no
New Brunswick	74	u	yes	—	—	—	72	s	no	75	u	no	—	—	—	75	u	no
Quebec	74	s	no	74	u	no	74	u	no	74	u	no	72	s	no	72	u	yes
Ontario	68	u	yes	68	u	yes	—	—	—	75	u	no	76	s	no	74	u	no
Manitoba	—	—	—	77	s	no	76	s	no	75	u	yes	75	u[a]	yes	75	u	yes
Saskatchewan	78	u	yes	45	u	yes	74	u	no	75	u	yes	75	u[a]	no	75	u	no
Alberta	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	60	u	no
British Columbia	—	—	—	—	—	—	—	—	—	74	u	no	75	u[a]	no	74	u	yes

Province	Visual Prostheses			Hearing Prostheses			Chiropractic Services			Podiatric Services			Orthopedic Ortheses and Prostheses		
	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF	Yr.	u/s	DF
Newfoundland	?	s	yes	71	s	no	—	—	—	—	—	—	50	s	no
Prince Edward Island	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Nova Scotia	—	—	—	—	—	—	—	—	—	—	—	—	81	u	no
New Brunswick	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Quebec	77	s	no	79	s	no	—	—	—	—	—	—	75	u	no
Ontario	—	—	—	82	s	yes	72	u	no	72	u	no	82	s	yes
Manitoba	82	s	yes	79/81	u	yes/yes	69	u	no	—	—	—	71	u	no
Saskatchewan	—	—	—	73	s	yes	73	u	no	—	—	—	75	u	no
Alberta	74	s	no	80	u	no	69	u	no	69	u	no	80	u	no
British Columbia	—	—	—	—	—	—	68	u	no	68	u	no	74	u	yes

Source: Canada, Department of Health and Welfare, Medical Services Consultative Committee, "Complementary Provincial Benefits: Information Exchange" (Ottawa: The Department, 1982).

Notes: The table lists only 11 complementary services. Many others exist in at least one province but are left out because they are not widespread. The universal/selective criterion is applied as follows: Is the program intended for a specific subgroup (because of age, means test, etc.) for the group with the identified need? For programs intended for children, the definition of a child (less than 18 years or 16 years, etc.) selected or used by the province is adopted. Medication programs for chronically ill persons differ considerably in the illnesses that are covered: cystic fibrosis, cancer, mental illness, diabetes, etc.

Yr: year of introduction; u/s: universal or selective; DF: deterrent fees

a. Part of universal medication program in these three provinces.

services subjected to national standards: this warning from Quebec led to the abandonment of the national standards without, however, preventing Quebec from opting out.[5]

Health insurance programs, unlike post-secondary education and public assistance, are the best known and most important example of the application of national standards to provincial public expenditures. Since the provinces seem to have successfully opposed the imposition of such standards on other programs, it is especially interesting to consider what led to a different outcome in the health sector. Three factors appear to have played a role:

- the specific nature of national standards in health insurance programs: the common principle underlying the two most important of these standards was the financial accessibility of health services to citizens;
- flexibility in applying national standards to allow them to be compatible with a decentralized health insurance plan; and
- the absence of a fully developed national health policy except for financial accessibility.

Financial Accessibility

Two of the national standards for health insurance are based on a single goal: to provide each Canadian citizen with the "right" to equal access to current hospital and medical services.

The transferability of benefits acquired by Canadians in one province when they move to another is only a specific extension of the financial accessibility of health services. This goal, rather than the more abstract one of promoting interprovincial mobility of manpower, is the one that tended to make financial access to health services a personal right of each citizen — a kind of extension of citizenship.[6]

The purpose of the universality rule was to ensure that the health insurance plan was equally accessible to all Canadians. This of course assumed that financial barriers would be removed but not necessarily that all health services would be free. In fact the first Hall Report took a very casual attitude to deterrent fees. And the *Hospital Insurance and Diagnostic Services Act*, in the same permissive spirit, limited itself to providing for the income derived from these fees to be deducted from shared expenses. In 1964, The Hall Commission (Royal Commission on Health Services) stated:

> The Commission is concerned, as it has said elsewhere, with the mounting cost of the hospital plan and believes, therefore, that the efforts of a province to introduce a greater degree of prudence in the use of these services, which are both reasonable and compatible with the spirit of the Act, should not be penalized.[7]

In short the aim was to prevent discrimination against certain classes of

individuals (including, obviously, low income earners) in order to ensure that all were protected equally by the same plan. The purpose of allowing the income from authorized fees to be deducted from the federal contribution was not to penalize the province imposing such fees, but to reflect the fact that the sharing was aimed at *government* expenditures on health and not all health-related expenses.

The federal government, in assuming a very heavy financial burden in the health care sector, was stating through these two national standards that it was taking on this burden to establish a benefit or an equal "right" for all Canadians, if not throughout Canada, at least within each of the provinces and also when Canadians move from one province to another. This uniformity, which was required whatever organization and regulation methods were decided upon by the provinces, was based on the direct link with each citizen that the federal government wished to affirm and consolidate in the exercise of its powers to tax and to spend.

Flexibility in Applying National Standards

In view of the direct link provided by universality and transferability between each citizen and the federal government in the exercise of its powers to tax and to spend, the purpose of the other national standards was primarily to define the goal of these transfers. Provided that the health services in a province were generally accessible without discrimination to all Canadians in that province, the provinces were free to change significantly the content of their health programs and the ways they administered them.

Contrary to what might be believed, the public administration standard was not an attempt to predetermine management methods for hospitals. The rule was specifically not intended to prevent private corporations, even profit-making corporations, from managing hospitals — nor did it have that effect. This is made clear in the first Hall Report, and it is also consistent with the survival of such hospital corporations — and to their recent reappearance in some provinces. In general, the purpose of the standard was to define the goal of the transfer program rather than to control the management of the program; that goal was to substitute a state monopoly for the private insurance companies, because the savings in administrative costs resulting from such a monopoly were expected to be a major source of financing for a universally accessible plan. The standard provided a definition for public plans, which were basically designed as state monopolies. Similarly, the "comprehensiveness" of the programs was limited to a reference to the services of medical doctors and to other "medically necessary" services: those are the only services covered by the equal access rule. The federal government did not attempt to impose its view of the ideal scope of health services or an optimum organization of such services, leaving

this to the provinces; its purpose rather was to guarantee that all such services, once defined, would be accessible to all Canadians.

Thus the whole range of health services was never included in the definition of insured services in any province, although some came closer than others, and there was never any federal pressure on the provinces to complete the coverage. Table 3-1 shows clearly the number and significance of these provincial variations.

The *Hospital Insurance and Diagnostic Services Act* (R.S.C., c. H-8) also defined "insured services" under this Act in reference to the provincial Acts (s. 2). Moreover, the Act stated that no regulation resulting from an agreement between the federal government and a province in reference to this program could be amended without the agreement of the province. As we shall see in the third section of this study, the provincial acts themselves were passed in response to the federal Act, and the latter logically and chronologically preceded the former, including its definition of insured services. The practical significance of listing insured services in the federal Act was, however, to *exclude* a number of services from cost sharing (psychiatric hospital services, sanatoria and reception centres and shelters) rather than to force the inclusion of additional services.

The Absence of a Federal Health Policy

This flexibility in the organization of health services and the existence of approximately 50 percent funding by the federal government alongside a wholly provincially operated delivery system, are not nearly as surprising as they might first appear. In fact the national health insurance programs had nothing to do with health policy and everything to do with providing equal access to such services, which is a very different matter. That is why the national accessibility standards, even interpreted broadly, were sufficient to ensure that the federal objective would be achieved.

From this standpoint, the design of the health programs made it possible for them to be coordinated with income security programs, but it left unsolved the problem of harmonizing health services between provinces. In this respect, the only harmonization mechanisms that existed and continue to exist were the successful cases of provincial innovations. At the outset and even long after the gradual introduction of a health insurance plan, action by the federal government was not intended to establish any specific view of a health services system, or even to promote health. When in the early 1970s, the federal Department of Health and Welfare began to publish the first documents outlining the main features of a health policy, such as the document entitled "A New Perspective on the Health of Canadians" and the Hastings Report on community health centres, it did so as a result of provincial initiatives

that had already been taken in these fields and at the same time as negotiations were being announced for what were to become the *Established Programs Financing Act*.

The development of a federal health policy came too late to have a significant influence on the plans that were financed in part by Ottawa. It was only in 1984, as we shall see later, that an attempt was made to use financial sanctions to make federal policies in this field more effective.

Limits on the Spending Power

Thus, in the field of social policy, especially health insurance, the various provincial acts were effectively harmonized. Not only did the various provinces pass very similar statutes within a very short time — and on two occasions, first in the late 1950s and again ten years later — but once again the various statutes contained common national standards. This successful harmonization can be attributed to the exercise of the spending power.

There are constitutional limits on the spending power, but these limits are imprecise because the provinces have chosen not to contest legally the use that the federal government has made of this authority over the years, even in the health sector, where Ottawa has exercised its authority very broadly indeed.

The power itself is not specifically mentioned in the Constitution; it is rather the result of legal interpretation, which has been firmly established through a few cases having to do with the exercise of this power in respect of individuals. There is no doubt that Parliament has the authority to make payments to individuals for any reason — even, for example, for purposes of education or under a policy having to do with families — two areas that the Constitution assigns to the provinces, at least where legislation on these matters is concerned. In other words, the distribution of legislative jurisdictions under sections 92 and 93 of the Constitution does not affect the federal government's power with respect to "the raising of money by any mode or system of taxation" or its power to use the proceeds as it deems fit. When the payments are to be made to private individuals, Parliament may attach conditions, but these conditions may not result in any substantial regulation of an activity over which the provinces have exclusive legislative jurisdiction. The courts have never been called upon to decide a case disputing a federal subsidy to a province, and one can only speculate about the boundary between allowable conditions and ultra vires conditions that may be attached to federal legislation providing for conditional payments to provinces.

The constitutional amendments of 1982 may have introduced a new problem for Parliament when it imposes conditions on the payments that it may authorize to the provinces. Not only must these conditions not constitute a method of legislating indirectly on questions that fall under

provincial legislative jurisdiction, but the withholding of any federal subsidy — if the condition is not met — must not imperil the delinquent province's ability to provide its residents with public services of reasonable quality. In fact section 36 of the Constitution provides that

> Parliament and the legislatures, together with the government of Canada and the provincial government, are committed to [. . .]
> e) providing essential public services of reasonable quality to all Canadians.

In the absence of any legal interpretation, the precise meaning of this provision must remain vague. It is nonetheless possible that section 36 may be invoked to invalidate the federal government's use of the sanction of non-payment of a conditional subsidy if any condition is not met. At the very least, the court would have to ensure that the condition imposed is absolutely essential to the responsible exercise of federal spending authority "in a free and democratic society."[8] Although this provision does not apply to Part III of the 1981 version of the Constitution, to which section 36 belongs, it is plausible to assume that the "commitment" provided for in it is not absolute but must be assessed in a specific context, namely, the need for the government to be accountable for its use of public funds. At the very least, this assumes — in connection with payments to the provinces — a definition of the purpose of the payments made, but perhaps not conformity to "national standards." Even if this power were compatible with national standards, then it would be possible for some standards to be acceptable and others not, depending on their purpose.

To a certain extent, the absence of legal action by the provinces concerning the legal basis for conditional payment programs is an indication of what conditions the provinces themselves feel are probably acceptable. It is clear that the lack of legal action does not amount to consent on the interpretation of the Constitution but, as long as the interpretation is reasonable, it at least provides useful markers of what is politically achievable without dispute and perhaps an indication of what rules of interpretation the courts could rely on if the matter were placed before them.

For approximately twenty years now, conditional payment programs to the provinces have largely been concentrated in health (hospital insurance and health insurance), public insurance and post-secondary education.

Even though the latter two areas belong to the category of conditional subsidy, they do not involve any national standard. The "condition" to which the transfers are subject is simply the province's obligation to spend an equivalent amount in the same area and, since the 1977 *Established Programs Act*, even this obligation has disappeared for post-secondary education. It is now sufficient for the province simply to maintain the program.

The health insurance sector is therefore the testing ground par excellence for the constitutional validity of the "national standards" that are imposed by Parliament as a condition that the provinces must satisfy to remain eligible for federal payments. This is even more significant in view of the fact that these conditions were confirmed in the new framework established in 1977 by the *Established Programs Act*.

The question of the validity of the conditions attached to federal government transfers to the provinces is not likely to be generally resolved by a yes or a no. Even though there are very few legal precedents, jurisprudence at least suggests that certain conditions may be considered valid and others not.

Some requirements are strictly formal: thus a federal program whose purpose is to underwrite half the cost of building a teaching hospital presupposes that satisfactory accounting standards have been used. This administrative requirement by the federal authorities is not a secondary appendix but is rather an integral part of the "condition" that gives its name to conditional grants. What is to be shared, under this assumption, is not any capital expenditures related to a teaching hospital, but only those expenditures that correspond to an established accounting model. This is a direct consequence of the federal government's responsibility to Parliament and its political obligation not to discriminate among provinces.

Other requirements are more significant. In particular, some conditional transfer programs could incorporate requirements concerning the value to citizens of the benefits deriving from the program. In the field of income security, the federal government is entitled to pay benefits directly to individuals; there is no apparent reason why it would be unconstitutional for the federal government to use a national standard to determine the payments to be made by a province toward the financing of a program in which it participates by means of intergovernmental transfers: it amounts to doing indirectly what it is legally entitled to do directly. In health and social services, accessibility rules are analogous to the rules concerning the amounts of income security benefits: it is these accessibility rules that determine who may benefit from these services and under what conditions.

Until 1984, the two health insurance programs contained requirements for national standards belonging to one of two categories:

- formal requirements, mainly to do with accounting, whose purpose is primarily to identify precisely the essence of the program, that is, the public administration of programs and their so-called "comprehensive character" (The characteristic of being medically required); and
- requirements based on accessibility, that is, transferability and universality.

To my knowledge these requirements have not been disputed before the

courts and if they had been, the cases would have been lost. This use of spending authority is within legitimate limits. The same cannot be said, however, for more recent innovations in health insurance.

Bill C-3 and the *Canada Health Act*, which was passed into law on the basis of the bill, are dubious efforts to extend the application of national standards to matters that have nothing to do with accessibility, and their success remains to be determined. Thus, subclause 12(d) of the bill provided among other things that "the health care insurance plan of a province [. . .] must provide for the payment of appropriate amounts to hospitals [. . .]." Under provincial pressure, the word "appropriate" was later removed because it appeared to indicate the federal government's intention to establish national standards for hospital funding. On the other hand, in the form in which the bill was passed into law, paragraph 12(2)(b) provides the right to arbitration when there are disputes between the provincial governments and the provincial medical associations; this provision would have the effect of making the rates for medical fees established under arbitration or conciliation a national standard. Such a standard has nothing to do with accessibility to the plan but rather with the management of the programs. If a province were to decide to dispute its validity (which is highly likely), and the courts were to decide against the province (which is much less likely), this would amount to a major extension of the federal government's spending authority.

Is the Spending Power Reversible?

Faced with a deficit that has become one of the main topics of debate among economists, the federal government is going to have to carefully reevaluate all its expenditures, and transfers to provinces are sure to be included in such a study. To this difficult financial situation are added political pressures for a thorough reevaluation of intergovernmental transfers: the political capital that the federal government acquired from the exercise of its spending power when the new expenditure programs were introduced was dissipated long ago. It may perhaps be regained by imposing new national standards on existing programs. This might induce the federal government to use its spending power to downsize programs and its commitments by threatening to reduce its transfers unless the provinces agree to adopt such new standards.

Such a strategy is not a mere assumption. The adoption of Bill C-3 as the *Canada Health Act* during the 1983–84 session stems directly from the context described above. In the debates that preceded its passage, the Act underwent many changes that affected its scope, but not its principal objective, which was to positively prohibit deterrent fees and extra-billing, which had only been discouraged by the earlier rule. This prohibition was ostensibly made more operational by weakening the

sanction that would result from infringement: instead of completely stopping its transfer, the federal government is henceforth authorized to deduct from the transfer an amount equal to the unauthorized charges. This new strategy for imposing national standards raises a number of problems that were not solved by the passage of Bill C-3. It will be a number of years before a definitive judgment can be made.

The offer of a federal subsidy to stimulate the development of a new provincial spending program was a very strong incentive for even the most reluctant provincial government. On three occasions the provinces, including Quebec, which was more opposed than any other province, were subjected to that pressure, especially with regard to the two shared-cost health programs, and to the additional pressure that would result from the fact that the residents of a province would "lose" — in their capacity as federal taxpayers — the federal government's financial contribution to a program that a province delayed implementing.

It would be difficult to recreate a comparable incentive by the reverse use of the spending power to make a marginal reduction in the federal subsidy as is provided for in the recent *Canada Health Act*. For a province, the suppression of deterrent fees leads by definition to a loss of revenue equivalent to the federal transfer that would be withheld if deterrent fees were to be maintained. From a financial point of view, provincial governments are therefore indifferent. The pressure on residents of the province, although not negligible, is obviously fairly weak, because although they "save" their part of the portion of the federal transfer withheld, they must pay all the deterrent fees — insofar as they make use of hospital services during the year. It is doubtful that most taxpayers will be able to make a rational distinction between these two opposite effects, because it will be difficult for them to evaluate the probability of how each alternative would affect them. It is therefore perfectly logical to assume that there is no real financial or political pressure on the provinces.

Extra-billing may appear to be an example that is more favourable to the effectiveness of the new incentive strategy, because it appears to benefit only a number of doctors rather than the provincial Treasury. However, to assume that the latter can simply prohibit extra-billing, with no costs to itself, would be to ignore the dynamics of the relations between provincial governments and medical associations. The most probable results of such a prohibition would be an increase in the fee schedules negotiated between provinces and physicians, with the result that medical doctors would now have an average income at least equal to that formerly produced by the standard fees plus extra-billing; in some cases, doctors' incomes would actually rise as a result of the extension to all doctors of the average extra-billing that formerly went only to some doctors. Paradoxically, the new federal legislation, by insisting on arbitration in the setting of medical fees may encourage such an upward

adjustment of fees. Even if this were to take place, the provincial governments are likely to be indifferent from a financial standpoint.

The use of the new negative incentive strategy is narrowly circumscribed by the two following restrictions. Politically it has been judged impractical to suspend all transfers to a province that does not follow national standards. This political difficulty has been given impetus by section 36 of the *Constitution Act, 1982*, which may have the effect of making such a radical sanction unconstitutional. As a result, the *Canada Health Act* allows a partial suspension of federal payments if a national standard has been violated, but the value of the suspension is proportional to the "infringement", which may also have the effect of making the sanction ineffective. To make it effective once again, it would appear that the financial sanction would have to be a multiple of the cost to a province of meeting a national standard without, however, making the punitive impact of the sanction capable of being interpreted as an infraction of section 36. In view of the uncertainty surrounding the legal interpretation of this section, the negative incentive strategy for the implementation of national standards leaves a great deal of leeway for subjective judgments.

Harmonization by Constitutional Amendment

Since 1982 Canada has had a procedure for amending its constitution that allows amendments to be made with the agreement of seven provinces having 50 percent of the population of Canada. It is not certain that this will make constitutional amendments any easier than in the past but, assuming that it does, it is a solution that will certainly be called upon to solve problems of harmonization in areas of social policy as in others.

In the past, the Constitution was amended twice in the social sphere to assign responsibilities to the federal government that had formerly been the preserve of the provinces: unemployment insurance and old age security. How can this transfer of powers be evaluated in terms of the harmonization of social policies?

In 1971, Quebec made a radically different suggestion for a new provision to be included in the Constitution: an overriding power for the provinces in matters of social policy. The provision was obviously not intended to ensure the harmonization of social policy from one province to another, but rather the harmonization of federal and provincial social policies for the residents of each of the provinces. It would be interesting to evaluate also the possible contribution of such a constitutional provision.

In general, as I shall attempt to demonstrate in the conclusion to this section of my study, a constitutional settlement of the problem of harmonizing social policy is difficult to reconcile with federalism: rather than solving problems of harmonization, such a procedure would appear to deny the relevance of federalism.

Constitutional Amendments with Respect to Unemployment Insurance and Old Age Security

The distribution of legislative powers as specified in sections 91 and 92 of the *Constitution Act, 1867*, has not often been amended. Twice however, in 1940 and 1951, the provinces gave their unanimous consent to amendments that gave Parliament jurisdiction in matters formerly on the list of provincial powers.[9] Both constitutional amendments were in the realm of social policy and related to programs that remain even today among the most important. The unusual solution taken in these cases suggests that the problems that had to be resolved must have been very special ones.

The amendments were first clearly put forth in the *Report of the Rowell-Sirois Commission* (Royal Commission on Federal-Provincial Relations). The same arguments were used for both amendments. Both unemployment insurance and old age pensions already appeared to be particularly burdensome government responsibilities and this, therefore, caused funding problems. The social philosophy of the period, or at least the philosophy espoused by the Commission, favoured financing by means of mandatory contributions. This was an attempt to keep general taxes down and, implicitly, to minimize income redistribution to the unemployed and the aged by means of the income tax through the use of uniform rate financing, which therefore had a regressive effect.

This social philosophy and funding option, once adopted, led automatically to the rest. In fact, as the Commission stated:

> [. . .] if compulsory contributory old age annuities are to be established in Canada, the matter cannot be left to the provinces. They are scarcely likely to have very strong incentives to establish their own systems; it would be undesirable if they did establish them. It is clear that only the Dominion could institute a compulsory system which would be administratively simple, which would not interfere with the free movement of labour, which could impose burdens on industry equally irrespective of provincial boundaries (and likewise on labour) [. . .][10]

This uniformity from one province to another was desirable because:

> The principal reason for this uniformity lies in the readiness of industry in one province to complain if it is taxed for social services which are provided out of general taxation in other provinces or are not provided at all in other provinces.[11]

In other words, the Commission was attempting to achieve uniform benefits under these two programs (especially unemployment insurance) in order not to reduce the mobility of labour, and it wished to have uniformity of funding in order to avoid affecting the competitive position of industry in the various provinces. The topic of manpower mobility was not developed further than the statements of principle made by the Royal Commission in 1937, and we shall see later that it continues to haunt any evaluations of the program.

At the time the Rowell-Sirois Commission was formulating its recommendations, unemployment insurance and social benefits to the elderly were being handled by means of federal transfers to the provinces. These transfers could have been increased if the Commission had deemed them to be not large enough, and the Commission itself had identified the concept of unconditional payments in 1957, which was introduced under the name of equalization payments, and which it could have recommended be used immediately to compensate for the very unequal impact of the economic depression and unemployment on the various provinces.[12]

In other words, although the Great Depression had in fact affected the various provinces in a very unequal way and although the provinces were unequal in their ability to pay the cost of assistance to the unemployed, this was not the determining reason for the recommendation to centralize unemployment insurance in Ottawa. In another part of its report, the Commission had proposed a solution to the problem of provincial fiscal disparities — a problem that was only partly attributable to the depression and that was to survive the centralization of the responsibility for unemployment insurance. Although the Rowell-Sirois Commission saw unemployment insurance as a vehicle for interregional redistribution, it did not want it to be a vehicle for social redistribution, and that is why it insisted on a strict social insurance plan that was self-financed and not dependent on contributions from the public Treasury. The Commission's social preferences made it impossible to use intergovernmental transfers as a means of interregional redistribution of the cost of unemployment insurance — an option that would have opened the door to disparities in contributions and benefits, as previously mentioned.

Similar reasoning was applied to old age pensions in 1950 in connection with the question of making universal a social program that formerly had been selective: the new component in old age security that was proposed at the time was to make eligible for old age pensions all persons who had not formerly been eligible because their income was higher than the median.[13] An extension of the old age pension to these people could not be justified on grounds of redistribution and, as a result, it was politically necessary to link this extension of coverage to equal and mandatory contributions.

In both cases, it was this way of viewing and financing the two social programs that was the true reason for the two amendments to the Constitution.

In fact, legal interpretation had already clearly stated, and would subsequently confirm, that the federal government could spend freely in areas of provincial jurisdiction (including assistance to the unemployed, social benefits to the aged and family allowances) but that it could not under the same legislation impose a mandatory contributory plan and use the proceeds to defray the expenditures involved. In other words, it could not establish a social insurance plan under a federal act.

In a decision in 1933 the Privy Council Legal Committee stated: "Now as to the power of the Dominion Parliament to impose taxation there is no doubt. But if the tax as imposed is linked up with an object which is illegal, the tax for that purpose must fall."[14] And, on the basis of this interpretation, the federal government's New Deal was judged ultra vires of Parliament. This New Deal specifically included a federal social insurance plan.[15]

This social philosophy and the economic environment in which it flourished were widespread enough to overcome any dissent. Thus the Social Insurance Commission, a public agency of the Quebec government, took the same point of view in its 1935 report, and the CCCL (Confederation of Canadian Catholic Labour), a Quebec Catholic union (which has since become the Confederation of National Trade Unions, or CNTU), did the same in its brief to the Rowell-Sirois Commission. This was a clear indication on two fronts that these considerations, even in Quebec, had more weight than any objections by those in favour of provincial autonomy to a transfer of jurisdiction to the federal government.[16]

Harmonization Does Not Require Uniformity: The Case of Unemployment Insurance

The Rowell-Sirois Commission was correct in emphasizing the possible effect of unemployment insurance on the allocation of resources and, in particular, of labour. It even foresaw that the program would have a different effect on protected industries and industries exposed to competition. Unfortunately, it did not take its analysis far enough, for uniform benefits and contributions for industries that are very different also have an unfavourable effect on manpower mobility and the allocation of resources.

Since the rate of unemployment varies from province to province, unemployment insurance is a permanent source of income redistribution from provinces with low unemployment to provinces with high unemployment. When the benefits paid in each province are not financed by contributions collected in these provinces, these transfers slow the migration of labour from high-unemployment regions to low-unemployment regions, because incomes are raised artificially where unemployment is high and lowered artificially where unemployment is lower. As a result, national production is lower than it would be if there were no such transfers. The uniformity of the federal unemployment insurance program therefore does not mean that the program is neutral in its effects; in fact, provincial unemployment insurance plans might have been more economically efficient.[17]

But interregional transfers are not the only problem resulting from a federal unemployment insurance plan. There are also transfers between industries, in particular those made to wage earners in industries with

great seasonal variations in unemployment (e.g., forestry, maritime fishing and construction). These transfers entail a permanent subsidy and thus an incentive for the development of those industrial sectors that do not make the most desirable use of their manpower and, by means of contributions from everyone, a disincentive to the development of industries that suffer less from seasonal cycles. Once again the redistributive effect of unemployment insurance also acts to the detriment of the national economy.[18]

The obstacles to geographical and industrial mobility that stem from a uniform Canadian unemployment insurance plan were made worse following major changes made in the early 1970s. In fact, since the early 1970s the unemployment insurance plan has increasingly taken on the characteristics of an income redistribution plan rather than an insurance plan. But even if the provinces had introduced their own plans on the basis of the same ideology, they would have had to rely on their own resources and, as a result, the redistributive emphasis in each individual provincial program would have been moderated.

Many authors who have studied federalism and social policy in federal systems have in fact expressed the idea that compared to a centralized country, a federal country restricts the expression of a distribution philosophy. Almost 30 years ago K.C. Wheare commented that the advantage of a federal constitution was that it made it possible to isolate prosperous regions from the full impact of the implicit and explicit redistribution that would naturally result in a centralist country.[19] More recently Keith G. Banting wrote:

> Cross-national studies have demonstrated a clear relationship between the scope of welfare and political centralization: other things being equal, countries with decentralized governments devote a smaller proportion of their resources to welfare than do those with centralized governments. In comparative terms, federalism is clearly a conservative force in welfare politics, and the analysis of Canadian experience [. . .] supports this proposition.[20]

The 1940 constitutional amendment concerning unemployment insurance brought Canada closer to centralism. But the increasing interest of Canadian governments since 1963 in the question of "regional disparities" would lead one to believe that regions are a legitimate frame of reference for evaluating economic performance. There would therefore appear to be a contradiction in the definition of the intended objectives when the desire to treat all Canadians equally in terms of unemployment insurance creates obstacles to manpower mobility that make it more difficult to eliminate these disparities.

There is no doubt that the unemployment insurance experiment in Canada shows clearly that the harmonization of social and economic policy is an objective that assumes, not necessarily the uniformity of these policies, but rather an adaptation to the different circumstances

that may obtain in the various areas. By producing uniformity, a constitutional amendment like the 1940 amendment goes farther than necessary and may even contribute to the country's economic problems rather than solve them.

In view of comments received by the author on an earlier version of this report, it is necessary to specify more clearly the import of the above comments on unemployment insurance:

- The question is not whether the Canadian unemployment insurance plan is "good" or "bad" according to economic or social criteria, or whether or not, assuming the plan is "bad," the federal government could improve it.
- In 1940 the constitutional amendment that gave exclusive jurisdiction in unemployment insurance to the federal government was presented as necessary for the harmonization of the plan with the economic policy of the federal government. (Although different language was used at the time, that was the essence of the argument.)
- The unemployment insurance experiment over the years shows clearly that this centralization was certainly not sufficient to produce the desired harmonization of federal policies. Because the redistributive potential of a centralized unemployment insurance plan was greater than that of provincial plans, some of the problems with the existing plan cannot be treated as mere accidents. If we accept this statement, it may be concluded that the centralization of unemployment insurance was not a *necessary precondition* for the harmonization of Canadian social and economic policies.
- The centralization of unemployment insurance greatly increased the seriousness of the problem of harmonizing federal and provincial social policies both in terms of benefits and administration. This is particularly true of the harmonization (an inappropriate word in this instance) between federal unemployment insurance and provincial social assistance programs.

Constitutional Amendments Complicate Harmonization: The Case of Old Age Security

A universal old age pension was proposed by the federal government at a federal-provincial conference in 1950. The purpose of the program was to make all Canadians 70 years or older eligible to receive a uniform old age pension of $40 a month. The benefit at the time was available only to those who could establish need, which admitted 45 percent of the target population, and expenses were shared on a fifty-fifty basis with the provinces; the plan had been in effect since 1927. Ottawa proposed continuing the cost-sharing agreement for a new old age assistance program, subject to the need criterion, for persons from 65 to 70 years of age; but the federal government alone was to bear the financial burden of

the new universal program for those over 70 years. The financing of the program was to be by means of mandatory contributions specifically for the program: 2 of the 10 percentage points of the manufacturers' sales tax, a 2 percent tax on corporate profits and a 2 percent tax on personal income tax to a maximum of $60. The need, recognized by all, for a constitutional amendment was due to the method of financing; all provinces agreed to it in 1951, and by January 1952 the program was in effect.[21]

Even before 1952, three provinces (British Columbia, Alberta and Saskatchewan) had been paying a special supplement to persons over 70 years of age. The 1950 federal proposal was not intended to prevent these practices, either in connection with the new universal pension for those over 70 years of age or for recipients of old age assistance. As we shall see later, these practices have continued and even proliferated.

However, the characteristic feature of this program, namely the fact that it was a contributory plan (which was what had made the constitutional amendment necessary), was later abandoned. Old age pensions and the guaranteed income supplement (under which the principle of selectivity was reintroduced into the income security plan for pensioners) have long been financed from the Consolidated Revenue Fund.

The transformation of the Old Age Security Plan into a non-contributory plan took place in two stages. The first was in 1971, when the taxation system underwent a thorough transformation following the work of the Royal Commission of Inquiry on Taxation (the Carter Commission). At that time new tax legislation combined the share of personal income tax, manufacturers' sales tax and corporation taxes that had been allocated to old age security and assigned to a special fund for pensions with all other income and other taxes. Eligibility for old age pensions had already been gradually lowered from 70 to 65 years without any increase in "contributions," and as a result the Old Age Security Fund had moved from a surplus position to a deficit position. In 1975, the government decided to solve the problem — by simply eliminating the Old Age Security Fund because the taxes used to finance it were no longer earmarked as such and there was no longer any means of increasing them to replenish the fund.[22]

The constitutional amendment of 1951 no longer has any application today because the plan depends on Parliament's spending power in the same way as the Family Allowances Plan.

The 1951 constitutional amendment kept the provincial legislatures' spending power intact and even explicitly maintained the concurrent legislative jurisdiction of the provinces in this field. This amendment, known as section 94A of the *Constitution Act, 1867*, ensures the provinces' "legislative supremacy" for it stipulates that no federal law shall affect the operation of any law present or future of a provincial legislature. We shall see later just how ambiguous is this provincial legislative supremacy. Nevertheless, it was a determining factor in the introduction

of the Quebec Pension Plan in 1964 as well as in the decision rules applicable to the Canada Pension Plan.[23]

This provincial spending power in the field of old age security continues to be used extensively. Table 3-2 shows the size of the provincial supplements as well as their disparity from province to province.

Although the creation of concurrent federal jurisdiction in a contributory pension plan has not led to uniformity, it may also be said that it has been unable to foster harmonization of social policies in general. The possibility of using the social benefits that it administers directly to increase its "legitimacy" vis-à-vis the provinces has a certain attraction to the federal government. As we shall see in the fourth section of this study, this attraction appears to have been powerful enough to lead the federal government to increase the benefits of "its" programs (unemployment insurance, old age security and family allowances) in the early 1970s rather than devote equivalent amounts to a guaranteed annual income plan that the provinces would probably have administered. Before 1952, old age security was on an equal footing with other income support plans, and if the plan had not been changed, this preferential treatment would not have developed.

Once again, it is important to emphasize that the question in which we are interested concerns the effect on the harmonization process of a constitutional amendment. In this connection let us examine the following points:

- The constitutional amendment of 1951 was not designed to create uniformity from one province to another in income security benefits to the aged. Such a uniformity does not exist any more today than it did in the past.
- In strictly constitutional terms, the amendment did not in the least affect the harmonization of social programs for the elderly administered by various levels of government.
- In practice, however, the amendment made it possible to replace the joint old age security program that existed from 1927 to 1951 with separate programs established respectively by the federal and provincial governments, with the result that there was an increased need for harmonization.

In this specific instance then, it is difficult to interpret the amending process as an instrument of harmonization.

Provincial Legislative Supremacy with Respect to Social Policy: The Stumbling Block of the Victoria Constitutional Conference

The 1951 amendment did not transfer the power to legislate on pensions from the provinces to Parliament; what it did was establish another area of concurrent jurisdiction. Moreover, the wording of section 94A, intro-

TABLE 3-2 Provincial Old Age Security Supplements, 1983

Provinces	Year of Introduction	Criterion	Frequency	Benefits for Single Person $	Maximum for Couple $	Total Cost (millions of dollars)
Nova Scotia	1973	GIS	annual	219	438	10.6
Ontario	1974	GIS	monthly	586	965	88.8
Manitoba	1974	GIS	quarterly	188	405	3.4
Saskatchewan	1975	GIS	monthly	300	540	5.6
Alberta	1973	GIS	monthly	1,140	2,280	70.6
British Columbia	1976	GIS	monthly	466	1,196	n.a.

Source: Health and Welfare Canada.
Note: "GIS" means the guaranteed income supplement, a federal program related to recipients' income from all sources.

duced into the Constitution by the 1951 amendment, specified that "no law [of the Parliament of Canada] shall affect the operation of any law present or future of a provincial legislature in relation to any such matter." This clause establishing legislative supremacy for the provinces nevertheless involved an ambiguity that later events would bring to the fore. At the time the Canada Pension Plan and the Quebec Pension Plan were established in 1965, Quebec made use of this power to insist on establishing its own pension plan and thus demonstrated that in this sphere, if a province were to insist on acting on its own and establishing its own plans, the federal government could not prevent it from doing so. Although this interpretation of provincial legislative supremacy in pension matters was clear, it was nevertheless impossible to know whether section 94A would allow a province to amend or establish restrictions that would be binding on federal pension legislation. In other words, if a province wished merely to make changes in a federal pension program rather than substitute its own program, it is not clear that it would be able to do so. In this sense, it has been said that the legislative supremacy in question is "illusory," because, for example, to replace the federal Old Age Security Plan, not only would legislation be required, but also financing for the provincial plan established to replace it.[24]

In 1969, when it was announced that there would be a constitutional review, which ended in the Victoria failure of June 1971, the federal government, in a document called *Income Security and Social Services*, proposed reversing the legislative supremacy granted to the provinces in section 94A. Quebec responded by proposing that provincial legislative supremacy in pensions be extended to other social benefits programs: family allowances, youth allowances, manpower training allowances and unemployment insurance.

This constitutional debate is of interest to us because, for the first time, Quebec's arguments for the extension and for provincial legislative supremacy itself were expressed in terms of harmonization of social programs and not only in terms of provincial autonomy.

This new rationale found its origin in the Report of the Commission of Inquiry on Health and Social Welfare, which in part three, on income security, illustrated the failure of the existing programs to solve the problem of poverty despite the large amounts of money devoted to social security. The Commission therefore concluded that what was required was a close integration of all income security programs in terms of common objectives and, leaving aside administrative (and constitutional) considerations, "in terms of individual and family needs." The Commission was consistent in including in its report an analysis of, and recommendations concerning, old age security, family allowances and unemployment insurance. As for the distribution, if not of powers, then at least of the responsibility for the various income security programs, the Commission concluded:

> 942. It should be recalled in this connection that Quebec governments which have succeeded each other for a number of years have insisted that Quebec, as a State, itself define its priorities in the field of social measures. We believe that this demand reflects a profound need of the Quebec people. That is why we have attempted to define the overall income security measures which meet these priorities and the imperatives of overall planning, without in any way taking the different levels of government into account. The impossibility of dividing the plans among governments, within the framework of an evaluation of needs and measures which must be taken to meet them adequately, sufficiently illustrates the precarious situation of jurisdictional breakdown in the field of income security.
>
> 943. With respect to coordination from the recipient's viewpoint, it is essential that the situation of manpower centres not be repeated. Local income security offices must carry out the functions of plans administered by the two levels of government. In other words, we believe that the recipients and public users must not in any case pay the cost of a dual jurisdiction, irrational from every viewpoint.

In practice, this type of approach postulated the harmonization under provincial authority of all social programs. To achieve this end, Quebec proposed, during the 1971 constitutional review, a new version of provincial legislative supremacy that would give a constitutional basis to the provincial "variation" of federal social appropriations. This plan provided:

1. federal administration and financing of existing income security plans or of plans that might one day replace them or supplement them;
2. determination by each of the provinces of eligibility rules, amounts of benefits, recovery rates and so on; and
3. fiscal equivalence between the cost of the program in each province, as modified by provincial legislation, and the cost of the federal program before provincial modification.

Two years later the federal government was to accept an arrangement that was identical in all respects to this model for family allowances, but at the time, it claimed not to understand Quebec's proposal and, at the final meeting on June 14, 1971, Mr. Trudeau stated that Quebec's demands with respect to legislative supremacy were unacceptable because they assumed replacing federal income security programs with provincial programs:

> Consequently, the constitutional change proposed by Quebec would, over the years, lead to an erosion of federal income security programmes and their replacement by purely provincial plans. The old and the poor in the wealthier Provinces might do as well in such circumstances as if the federal government were making the payments, but in the other provinces including Quebec, the tax base would not support as good income security payments as Parliament could provide.[25]

After that had been said publicly, negotiations continued behind closed doors until late into the night, following which sections 44 and 45

appeared in the proposed Charter. Essentially, these sections were to replace section 94A; their purpose was to broaden the definition of concurrent social policy subject to provincial legislative supremacy in the manner desired by Quebec (family allowances, youth allowances and occupational training allowances); unemployment insurance was excepted, however. On the other hand, the concept of legislative supremacy — including its inherent ambiguity — was not specified further. Quebec wanted the supremacy to be clearly defined as the power to *modify* rather than to *replace* federal social payments, and the power of replacement to be accompanied by the right to fiscal compensation for any province exercising this power. since these two concessions were not obtained, Quebec refused, on June 23, to sign the Victoria Charter.

Quebec was not attempting to deny the existence of federal spending authority, but rather to restrict the exercise of this authority in such a way as to make social allowances paid to citizens by the federal government consistent with provincial social policies. The purpose of that goal appears to have been to obtain a constitutional base for the administrative arrangements that resulted later and which, for example, made it possible for the provinces (especially Quebec) to modify federal family allowances.

The fact that these arrangements have been working well for some ten years now shows clearly that Quebec's objective was achievable and not likely to lead to instability or decay. Moreover, unlike the constitutional amendments of 1940 and 1951, which were not harmonization mechanisms but rather centralization mechanisms, Quebec's 1971 proposal would have led, not to the provincialization of income security programs, but to a provincial variation intended to harmonize programs that would have continued to be federal programs.

The reasons for the failure are many, and it is impossible to evaluate the importance of each. These reasons are both technical and political. Among the technical reasons, the very newness of the idea of provincial variation of federal programs as a means of harmonizing social policies must be mentioned. This concept was introduced during the discussions in January 1971, whereas the constitutional negotiations themselves had begun in 1969 and an outline of a consensus, excluding this aspect, had already been agreed upon the previous month. Any new idea is liable to be misunderstood at the outset, especially if it is introduced within the context of negotiations. Moreover, the concept itself contained an ambiguity that was not specifically pointed out at the time but which was bound to cause misunderstandings.

In the absence of any judicial interpretation (for which we might still be waiting), the amendment proposed by Quebec opened the door to distortions which, on the one hand, could have deprived it of most of its effect, or on the other hand, made of it a provision incompatible with the continuance of federalism. First, if it were given a restrictive sense, only

federal social allowances would have been subject to provincial legislative supremacy. The federal government then would probably have been able to circumvent the new constraint by turning its social allowances into tax credits.

If, on the other hand, provincial legislative supremacy over social policy were interpreted broadly, almost all federal government activity would become subject, in terms of its "social" impact at least, to current or future provincial legislation. One matter in particular falls clearly into the category of "social policies" as understood in this way, and that is the whole area of taxation, especially the personal income tax. In all countries, personal income tax has long played an important role in social policy because it is the instrument par excellence for income redistribution. The income-progressivity of the tax due to the rate structure as well as basic exemptions (tax exemptions for children, child care, education, exemptions for other dependants, age exemptions) and the definition of the tax base for inclusion or exclusion of social benefits — all are components that must be considered as part of an overall social policy.

It is difficult to reconcile the federalist principle of non-subordination between the various levels of government with the legislative "supremacy" of one level or the other in social policy if that is interpreted to include taxation. Yet, if the latter is excluded, this partial supremacy loses almost all meaning.

However, the political reasons for the failure were perhaps more important. On the federal side, the loss of decision-making power over income security programs, except in terms of their "average value," was not compensated for by the continuation of federal administration of the programs. Province-by-province harmonization of income security programs was a solution entirely opposite to the one sought by Ottawa, which involved national standards. It was moreover a solution that reflected poorly the relative contributions of Ottawa and the provinces to the financing of income security (85 percent compared to 15 percent if the federal share of social assistance is taken into account). Had Quebec won its case, federal spending authority would have been used largely to maintain provincial standards rather than national standards and the ultimate erosion of federal financing and the political interest of the federal government in income security, as predicted by Prime Minister Trudeau, would perhaps have occurred.

For Quebec and its provincial government, the political situation was unfavourable to the success of its official position. For some, the introduction at the last minute of this new and contentious element into the constitutional debate increased the likelihood of failure and therefore appeared inopportune; for others, who did not want to see the constitutional review meet with success, the very difficulty of the case created a situation to be exploited. Under these circumstances, neither party had any interest in pleading its case too persuasively.

We conclude this study of constitutional amendment as a means of harmonizing social policy by noting the following:

- Paradoxically, the Canadian Constitution was amended twice to give the federal government the power to establish social insurance plans, but once created, the two plans evolved away from the idea of a social insurance plan to become, instead, a method of redistribution.
- For unemployment insurance, the uniformity thus created is probably unfavourable to the Canadian economy, because in this field uniformity goes beyond the requirements for harmonization, whose goal would merely have been to minimize the unfavourable impact of the plan on the economy.
- As for old age security, the constitutional amendment produced neither harmonization nor uniformity and, except for a very short time, the amendment itself was an exercise in futility.
- Quebec's effort to have its own supremacy in social matters enshrined in the Constitution failed because, on the political level, this inclusion involved a change that was either "too much" or "too little," depending on one's point of view.
- Quebec's proposal clearly brought out the fact that harmonization could be based on provincial objectives as well as federal objectives and could thus be one of the dimensions of the distribution of powers. As a corollary, harmonization must be clearly delimited; otherwise it may rapidly contradict the principles of a federal constitution.

To summarize, it would appear that constitutional law has not yet been able to define fixed rules to allow harmonization to be used to eliminate disparities in social policies. An inflexible and absolute cure may be worse than the disease, and this should not be surprising. Harmonization can result only from dynamic adjustments and, for this reason, it requires movement. Ideally, the Constitution should be able to provide constitutional mechanisms to foster adjustment, coordinate change, and so on, but as yet the constitutional solutions adopted in Canada have not been of this kind, but instead have involved structural change in the distribution of powers.

The solution proposed by Quebec in 1971 was not a structural one but a functional one. In this sense, it was probably a step in the right direction. However, by giving each province the power to harmonize its own social policies on the basis of provincial standards, it contradicted the financial realities of the Canadian federation.

Consensual Harmonization

The two preceding sections of this study have analyzed harmonization-mechanisms that are essentially unilateral. The Federal spending power, on the one hand, introduced a very strong incentive for the provinces to accept the conditions — in other words, a number of specified national

standards — as the price for obtaining funding from the federal government, but it was the latter that alone held the power. Moreover, the constitutional provisions under which some government responsibilities were centralized, or under which Quebec attempted to provincialize them, also led to unilateral solutions of the harmonization problem.

This section will examine harmonization experiments based on the parallel action of the governments involved, without recourse to financial or constitutional instruments that give the final say to one or the other.

Although there are few such experiments, those that have taken place are extremely important, not only because of what they illustrate but also because of the intrinsic significance, including the financial significance, of the social programs involved, i.e., federal family allowances and the Canada and Quebec Pension Plans. Finally, we shall analyze the "agreements" that have been concluded in federal-provincial relations.

Family Allowances: Provincial Variation of Federal Benefits since 1974

Following the failure of the Victoria Constitutional Conference in 1971, the federal government, which had rejected Quebec's demand for legislative supremacy in social policy, announced that it was prepared to consider "administrative arrangements" that could satisfy the concerns expressed by Quebec on the subject of the harmonization of various social policies applicable to Quebec residents. In this connection, family allowances were to play an important role. In fact, the Commission of Inquiry on Health and Social Welfare had already formulated specific objectives with respect to income security. These objectives were to provide all families and individuals with a sufficient income (defined in relation to a "poverty line" established objectively according to a number of criteria) and also to improve the incentive to beneficiaries for complete social integration, including participation in the labour force. Having observed that poverty was strongly concentrated in families with children and that there was a direct relation with family size, the continuation of, or even a substantial increase in, universal family allowances was seen as the ideal solution to both problems. High family allowances that would increase with the size of families would make it possible to offset the income shortfall for a large proportion of children living in poverty, and the universality of these allowances would make it possible to achieve a high level of income maintenance without creating the disincentives to work that would result from an income guarantee under social assistance at the same level, with its 100 percent tax back rate.

That is why Quebec had formerly been opposed to the federal plan for provincial allowances that would decrease with family income. Following the appointment of a new federal minister of Health and Welfare and

the failure of the Victoria Constitutional Conference, the federal government proposed a new universal family allowance plan, which would increase the budget for this item by almost threefold.

The federal Act provides for payment of an average amount per person in the form of a uniform allowance for all children 16 years of age or under living in a province, or in the form of varying allowances as determined by provincial law.

> Subsection 3 (2):
> In a province that has, by provincial law, specified rates for family allowances in respect of children whose parents are resident in the province, there shall be paid out of the Consolidated Revenue Fund, for each month, instead of the amount authorized under subsection (1), a family allowance in an amount determined in accordance with such rates [. . .]
> Subsection 4 (1):
> [Under this Act, the expression "provincial legislation" means for a province]
> (a) an Act of the legislature of the province that specifies rates for family allowances in respect of children whose parents are resident in the province based on the age of such children or on the number of children in a family or both and that
> (i) will result, in the payment of family allowances in each month in respect of each child to whom the law applies of an amount not less than 60 percent of the family allowance authorized under subsection 3(1). [i.e., $20 indexed since 1974[26]]

In principle, all federal social allowances would lend themselves to this type of provincial modification to harmonize them with the social policy of the various provinces. In practice, family allowances were the only program in which this modification has been possible and, even for this program, only two provinces — Quebec and Alberta — availed themselves of that flexibility.

The reason why this particular plan for family allowances was introduced in 1974 is the same reason why this harmonization method was not extended to other programs; in general, there is no political incentive for the federal government to move in this direction because the harmonization permitted takes place in terms of provincial objectives. However, the introduction of this method for family allowances in 1974 was the price to be paid for having rejected the position defended by Quebec at the Victoria Constitutional Conference. Ottawa had claimed at the time that Quebec's objectives could be achieved without constitutional amendment, and it intended to prove that it had been right. After the federal government had used family allowances to prove its point, the question disappeared from the political agenda.

In 1978 the federal government introduced a new program relating to family contributions in the form of a tax credit. In doing so it was returning, basically, to a concept proposed in 1970 and it entirely left aside the possibility of provincial variations.

The absence of debate, even in Quebec, when all of this was taking place illustrates the accidental nature of the effort to harmonize federal and provincial policies. From 1970 to 1973 the question of family allowances had been in the forefront of the discussions between Ottawa and Quebec and had been the source of considerable public friction. However, the solution that had been developed following a long and arduous process and to which one would have expected Quebec at least to attach a great deal of importance, was partly set aside without comment. Admittedly the government of Quebec was at the same time introducing a labour income supplement plan, and the new child tax credit was enabling it to save a large portion of the funds necessary for its implementation. Moreover, in the pre-referendum Quebec of the period, the two main political forces each had their own reasons to side-step the question. The separatists had no desire to remind the public of the existence of an original federal-provincial harmonization formula, and the federalists did not wish to call attention to the discarding of a federal-provincial "agreement."

Other federal programs were formulated in such a way as to allow for consultation with provincial governments about application methods. It is worth mentioning them here, even though it would be going too far to refer to them as instances of successful harmonization of social policies. The consultation process was used in particular for a number of job creation programs. In some cases, such as the Local Initiatives Program (LIP), consultation made it possible for the provinces to reject certain projects as unsuitable (and to take responsibility for the rejection), but that was the provinces' only role. The Local Employment Assistance and Development Program, which was established in 1972 and which still exists, provides for formal consultation with the provinces through a "provincial review committee." Also, the Job Creation Program that has been funded and administered by the Unemployment Insurance Commission since 1979 operates on the basis of projects submitted by the provinces and evaluated by the federal Treasury Board. These are the only two programs that specifically provide for a provincial role; that role is limited to secondary participation in program administration and does not bear directly on the allocation of funds. Not only is there no legislative "delegation" (unlike the family allowance program), there is also no administrative delegation. Finally, the funds allocated to these job creation programs are only a small part of the total funds devoted to all employment programs during the 1970s. The same is true of the present decade; in 1981–82 there were:

- two youth programs, entirely federal, totalling $106,000,000; and
- nine general adult programs totalling $289,000,000 and comprising seven wholly federal programs totalling $159,000,000 and two programs with provincial participation totalling $130,000,000.

The Canada Pension Plan and the Quebec Pension Plan

In 1964 the province of Quebec, referring to section 94A of the *Constitution Act, 1867*, the origins of which were described in the second section of this study, insisted on establishing its own pension plan. Its reason for doing so went beyond an affirmation of its constitutional power and lay in its preference for a pension plan that was at least partly capitalized. Constitutionally, legislatively and financially, the two plans are entirely distinct and independent. However, no doubt for the same reasons that struck those who wrote the Rowell-Sirois Commission's Report in 1937 — that is, the economic disadvantages of different social insurance plans in a single economic space — the two plans were identical at the outset and, over a 20-year period have developed in a very similar fashion. Table 3-3 shows the similarities in contributions and benefits for 1984, at which time the two plans had been in force for 18 years.

The table slightly exaggerates the similarities in the two plans, because it does not take into account such rules as the exclusion period for benefits for spouses who temporarily leave the workforce to take care of children seven years or under — a provision of the Quebec plan since 1977 that was added to the Canada Pension Plan (CPP) very late, even though it was added retroactively. Other rules, such as those bearing on the computation of the pension for persons between the ages of 65 and 70 years, were different for a number of years before being harmonized.

The establishment of the Quebec Pension Plan (QPP) is the illustration par excellence of the exercise of provincial legislative supremacy interpreted as the power to exclude federal legislation and social programs by providing substitutes for them. The similarities between the Quebec and Canada plans show clearly that formal powers are not always necessary to achieve a high degree of harmonization, since the same social aspirations and economic conditions will usually lead to similar — if not identical — pressure on governments. The common social and economic context is also very important, especially when such programs are being introduced. In commenting on the events that led to the simultaneous establishment of the CPP and the QPP, Claude Morin wonders whether Quebec could have acted alone and finally concludes that the answer is yes; however, he leaves no doubt about the strength of the pressure that would have been brought to bear on the government of Quebec against the plan if there had not been a similar plan being introduced in the rest of Canada.[27]

The rules that determine how the Canada Pension Plan can evolve are an even more interesting example of the potential and problems in a consensual approach to the harmonization of social policies. The rules specify that the plan can be amended only with the assent of two-thirds of the provinces representing two-thirds of Canada's population. This

TABLE 3-3 Comparison of Canada Pension Plan and Quebec Pension Plan after 20 years

	Canada Pension Plan (in dollars)	Quebec Pension Plan (in dollars)
Maximum contributory earnings	20,800.00	20,800.00
Basic exemptions	2,000.00	2,000.00
Annual maximum contribution		
Employees	338.40	338.40
Self-employed	676.80	676.80
Maximum benefits		
Death benefits	2,080.00	2,080.00
Survivor's benefit		
Under 55 years	229.18	360.00
55 to 65 years	229.18	420.31
65 years and over	232.50	232.50
Orphan's pension	83.87	29.00
Disability benefit		
100 percent disability pension	374.50	505.57
Disabled child pension	83.87	29.00
Maximum retirement pension	387.50	387.50

rule is stricter than the one that is now contained in the Constitution concerning amendments to the distribution of powers, for such amendments now require the assent of two-thirds of the provinces but only half the population. Moreover, although Quebec has its own plan, it participates on an equal footing in decisions affecting the Canada Pension Plan: because of its population and the two-thirds rule, its weight is that much greater than in constitutional amendments. Finally, the federal government may also oppose any amendments of which it disapproves.[28]

These extremely strict rules have meant that the Canada Pension Plan has evolved more slowly than it would have otherwise. Paradoxically, this slowness probably caused the QPP to evolve more slowly because of the importance attached to keeping the two plans similar. Banting notes two other consequences of the high level of consensus required by the CPP:

- Growing importance was given to the guaranteed income supplement for the elderly, an exclusively federal program.
- The balance that existed in 1966 between private and public pension plans was continued.[29]

Intergovernmental Agreements in the Social Field

The abundance of federal-provincial "negotiations" on a very broad range of topics would lead us to assume that their purpose is the signing

of formal agreements, or even contracts. Political rhetoric also often uses the word "agreement" even when what is meant is the discussion of the formula to be used to establish equalization payments — a striking illustration of the sovereign power of the federal government. A political consensus is a moral commitment that is unenforceable, at least before the courts and often even before public opinion.

Sometimes, however, the use of the expression "federal-provincial agreement" appears to be somewhat more accurate, and there are even provisions in legislation that make reference to it. Is it then a formal instrument for intergovernmental coordination?

The example par excellence of a legislative reference to intergovernmental agreements is found in the federal *Hospital Insurance and Diagnostic Services Act* of 1957. According to this Act, before the government paid its contribution toward the costs of the hospital insurance plan, there had to be an "agreement" between the federal minister of health and the province in question. The purpose of the accord was to specify the terms for the plan in the province (insured hospital institutions, authorized fees, etc.); the Act also provided that the regulation under which such an agreement would be signed could not subsequently be changed without the approval of the province.[30]

Legally, such an accord would appear to be a contract predetermined by one party insofar as its purpose, contents and methods of application are largely predetermined by the federal Act. Once a province signs, the principal terms of the agreement are applicable without any possibility of negotiation. The only choice left up to the province is not to participate, depending on the political climate. Despite the risks involved in any political decision, the freedom of choice here is a real one, as evidenced by the four-year delay between the passage of the federal Act in 1957 and its application, in 1961, to Quebec, the last province to join. Since it involved a free choice, this sort of agreement would appear to possess that characteristic essential to the validity of any contract.

Even though such an agreement is valid, however, a question arises about its enforceability. The federal minister is committed to the contracting province "subject to the Act," including any future amendments, and the enabling power assigned to the federal minister to conclude agreements with the provinces does not include the power to bind Parliament in the exercise of its sovereign legislative power. The obligation to obtain the assent of the contracting province before amending the federal regulations under which the agreement was signed, could perhaps make any unilateral regulatory change invalid unless it were subsequently ratified by Parliament. It is clear that, from a legal standpoint, any contractual limitation of the power to legislate and regulate would be interpreted very strictly. Without express constitutional provisions allowing the federal and provincial governments to be bound mutually and to bind Parliament and the legislatures by means of prior legislative

authorization or ratification, it must be concluded that intergovernmental agreements last only as long as the political will that made them possible at the outset.

Since the provinces have never brought any case involving such agreements before the courts, there are no legal precedents to assist us; "and this is the case for the very good reason that the provinces, who were the only parties likely ever to oppose the agreements, believed on the contrary that the agreements were to their economic if not their political benefit"[31] [translation].

Although the "economic benefit" to the provinces was substantial and obvious at the time the cost-sharing agreements for a number of social programs were concluded, that was not the case when the federal contribution was unilaterally adjusted downward. Thus in 1975, in his budget speech, the federal minister of finance announced — without any prior consultation with the provinces — a ceiling on the growth rate of federal health insurance contributions. The following year, the indexing of federal family allowances was similarly suspended. In a related area, post-secondary education, there had been a ceiling on federal participation since 1972.[32]

We referred above to the setting aside of the administrative arrangements on family allowances between Ottawa and Quebec when the child tax credit was introduced. In the social field, one could add the accord on global financing of social services, which represented funding principles already provided for in the *Established Programs Financing Act*. Also in 1978, the federal government decided not to legislate on this accord, which it had already signed with the provinces after years of negotiation.

From the financial standpoint at least, these examples of unilateral amendments made by the federal government to joint programs are a concrete illustration of the fragility of the agreements, a fragility that had already been identified in the analysis of their legal status. In fact then, they are not really agreements at all because they do not create any obligations that are binding for the parties — even for the provinces they add nothing more than a certain gloss to the unilateral exercise of federal spending authority. In 1960, Jean Lesage, then premier of Quebec, announced that he would no longer sign any federal-provincial agreements. Following his announcement, the federal government made sure that any new federal programs based on the federal spending power could apply without the need for explicit agreements with the provinces but rather by their simply joining. For this reason, the 1966 federal *Medical Care Act* differs from the 1957 *Hospital Insurance Act*.[33]

Conclusions

In the current constitutional context, the harmonization of social policies by consensus is the result of a political coincidence rather than a normal and reliable mechanism. Apart from the Canada Pension Plan,

there is no social policy whose development was submitted to a formal co-determination process. Provincial modulation of federal family allowances is an unintended side effect of the failure of the Victoria Constitutional Conference, and it has no value as a precedent. The agreements that are involved in a number of social programs are probably not enforceable, and the programs themselves may be revoked and changed at any time, as experience has shown, because their only foundation is the federal government's unilateral spending power. The inalienable sovereignty of Parliament and the legislatures makes it impossible for it to be otherwise without constitutional amendment.

Although it is easy to dispose of the question of the existence of a federal-provincial co-determination mechanism for social policies, the question of the possibility of creating such a mechanism is more difficult. At most, the following comments are possible:

- The difficulty of reaching a consensus on expensive policies that have a direct impact on citizens means that a co-determination mechanism for social policies will always have the effect of inhibiting change and especially, perhaps, of restricting development. This is clearly a political choice.[34]
- In view of this inhibiting effect, if the consensual mechanism applies only to certain questions, then the arrangement of the various social policies will reflect the disparities that exist in the decision-making mechanisms as much as they reflect social preferences. This is a situation to be avoided unless the disparity is clearly anticipated and the effects deliberately sought. For example, governments appear to have difficulty preserving the integrity of social insurance plans unless they are encouraged to do so by relatively burdensome decision-making mechanisms.
- The well-known fragility of federal-provincial agreements and cost-sharing programs (including the financing of established programs) would appear to make desirable, if not inevitable, a more binding contractual mechanism for increasing the stability of financial and intergovernmental commitments.
- The co-determination of social policies is one possible solution only insofar as the policies continue to derive from a shared jurisdiction. The mechanism is therefore an intermediary between the perpetuation of the unrestricted federal spending power on the one hand and, on the other, the legislative supremacy of the provinces (of the type that involves provincial variation of federal allowances).

Limitations on the Harmonization of Social Policies: The Failure of the Social Security Review

From 1973 to 1977 Canada underwent one of the most ambitious undertakings ever attempted in peacetime: the complete review of all income

security policies. The process was not the work of a single government, which in itself would have been unprecedented, but rather a particularly difficult effort involving the joint work of the federal government and the provinces.

At the outset, the undertaking involved purely redistributive programs such as social assistance as well as social insurance programs. As we shall see later, the real scope of the review was not as broad as that but it nevertheless covered a very large field, including the public pension plans, family allowances and, of course, social assistance and the various plans to provide a "guaranteed annual income." In addition, the review covered social services, including employment creation programs and human resources retraining programs.

The description of the terms of reference and work carried out by the committees of public servants and ministers who considered these matters may be found in various sources,[35] and shall not be repeated here. My purpose is rather to analyze that mandate and the significance of the failure of this enormous effort. The word "failure" does not apply to the whole of the review exercise. In fact, the first concrete result of the review was the profound change in the family allowance plan and the considerably greater funding provided to it: the purpose of the changes was to allow the provinces to modify the federal allowances, as was described above, and funding was increased threefold. In a similar — although less spectacular — way the federal-provincial review of social security made it possible to achieve significant agreement on the development of the pension plan as well as on cost-sharing for social services benefits.

Only one of the review objectives was not met — the objective to establish a guaranteed annual income for Canadians. Since, however, this objective lay at the very heart of the process and was in fact its raison d'être, the failure to achieve it despite the immense effort involved in the global review of social security remains a very important event that contains a number of useful lessons. Although it may be possible to learn from the experience, it is to be expected that at least some of the lessons to be learned involve the federal-provincial harmonization of social policies. The very scope of the mandate that had been taken on by federal and provincial social affairs ministers made such a harmonization indispensable. The failure of the undertaking may probably be taken to define the inherent limits of such harmonization efforts.

Circumstantial Reasons for the Failure

The word "failure," which has been used to describe the outcome of Canada's social security review process, has strong emotional connotations. In particular, most of the people who, over a four-year period, devoted their time and energy to the undertaking, naturally resist having their effort described as a failure. There are certainly many external

circumstances that may be called upon to explain the lack of concrete results following from the intense social planning exercise that took place from 1973 to 1977. It is even more tempting to fall back on circumstantial reasons because it makes it possible to eliminate two of the most threatening hypotheses. One of these is that Canada may have implicitly rejected, using the changed economic environment as a pretext, the idea of social equity that was being proposed as an objective. It may also be that our political system instinctively refused to give its assent to a project that entailed too many changes in the structure of government policies and even political power itself. These two hypotheses are not mutually exclusive.

Two unforeseeable circumstances are claimed to have caused the failure of the social security review. The first is the rapid changes in the economy that coincided with the beginning of the social security review. In the fall of 1973, the first oil crisis ushered in an inflationary spiral on a scale not seen for over 20 years. Not only did the prices of oil and raw materials skyrocket, but as a consequence there was a massive shift of wealth toward the OPEC (Organization of Petroleum Exporting) countries, as well as from one part of Canada to another. This new situation, whose ramifications gradually appeared during 1974 and 1975, was a most unpropitious background for a reasoned consideration of social security because, interregionally at least, the lines between who was "rich" and who was "poor" were no longer clear. The Canadian government, having decided moreover to protect energy consumers from the full impact of what was happening on a world scale, acquired at the same time a new fiscal responsibility that supplanted other priorities.

From another standpoint these years also saw successive transformations of the political climate. At the federal level, the decision to launch this global evaluation and review of social security was made by a minority government whose survival depended on the support of the New Democratic Party. It is obvious — and the decision concerning family allowances proved it — that such an evaluation had to take place from an expansionist point of view. From the 1974 summer elections onward, the precarious situation came to an end and a majority government acquired the freedom to manoeuvre what it had lost in part from 1972 to 1974.

These circumstances, which were to change profoundly the economic and political climate of the mid-1970s, offered plausible arguments to those who held that the failure of social security review did not reflect any fundamental defect in the goal or the decision-making process used to achieve it. However, plausible arguments are not necessarily cogent arguments.

The first oil crisis, whatever its importance may have been for international economic relations, had only a moderate effect on Canada, particularly on Canadian public financing. Until 1980, subsidies for oil imports were offset by export duties and excise taxes on gasoline, thus

resulting in a net positive fiscal balance on oil for five of the six years following 1973.[36] It is true that from 1975 onward the battle against inflation became a priority, but it was essentially a short-term cyclical policy. Insofar as even social programs were affected (by the de-indexing of family allowances in 1976), they were affected only for a single year.

The introduction in 1978 of the child tax credit, which came about long after the return of a majority government, also shows that the global review of income security was not merely the by-product of temporary parliamentary circumstances. The broadening of unemployment insurance preceded this situation, just as the introduction of the child tax credit followed it. The objective of improving social security was not abandoned in 1974.

There is no question of denying the relevance of the economic and political events that took place during this period to the outcome of the social security review. Bureaucracies and governments, both federal and provincial, are not all of a piece; on the contrary, among them are those who are opposed to objectives which, at one time or another are top priority. Accidental events sometimes strengthen the point of view of those opposed and provide opportunities for them to be more persuasive, but it would be a mistake to exaggerate their importance. There is no doubt that circumstances are no more than that — circumstances and not causes, either sufficient or necessary, of the failure of the income security review. In other words, it is very doubtful that the failure could have been avoided, even if there had been no world oil crisis and even if the political situation had not changed.

An Unjustified Assumption Relating to Social Consensus

An ideal of social justice and effectiveness as ambitious as the global review of social security carried within itself the seeds of the disappointment that was to be felt by those who had devoted themselves to it and given it shape. It involved developing an ultimate reform of social security that would make any future reform unnecessary, and designing a perfect plan along with a rigorous, objective and non-discriminatory definition of the "just society." There were essential components to the plan:

- the universal right of every person to a "poverty line" rigorously set in a uniform fashion for all those who found themselves in need and with identical incomes; and
- incentives to join or remain in the labour force assumed to result from a smooth transition between a social benefit reduction rate and the tax rate on employment income; the system being designed in such a way as to achieve perfect continuity from social assistance recipients to the better paid wage earners, in terms of their financial relations with government.

Such a plan, if it were possible to spell out the mode of implementation, was so perfect that it met with unanimous approval from one end of the social philosophy spectrum to the other. On the right it was solidly based on the long-standing proposals of Milton Friedman for a negative tax; at the same time it had the support of the left for its promise to establish a consistent form of redistribution and to eliminate any kind of value judgment concerning the relative merits of the various categories of low-income individuals.

The desire to establish a perfect system was in no way arrogant. In 1966 the introduction of the Canada Public Assistance Plan had ratified the elimination in social assistance of the old discriminatory categories: single mothers with children, the blind, the handicapped, unemployed persons who had used up their right to unemployment benefits and so on. It even seemed possible to eliminate a final barrier, the barrier separating those who were part of the labour force from those who are not. What was proposed was nothing less than to make social assistance rules universal. Had we not come as far as we had by means of a gradual broadening of the concept? What then could be more natural than to continue along the same path?

During the 1960s, there had been other equally ambitious proposals for social reform. The Carter Commission (Royal Commission of Inquiry on Taxation) had drawn up a program of tax reform based, among other things, on the famous statement that "a dollar is a dollar is a dollar." The strength of these recommendations, like the intellectual attractions of a global review of income security, lay precisely in this belief that it was possible to measure the equity of the taxation system as well as the equity of income security programs using the simple and sole criterion of monetary income. The real world, in its diversity, was thus conveniently reduced to a single dimension. Looked at from this standpoint, the problem of taxation, as well as the social problem, could therefore be "perfectly" solved. From this standpoint alone, the paraplegic and the construction worker both had an income and the only difference was its level, but the logic involved treated them as if their positions were interchangeable.

During this same period, similar social security reform proposals made in the United States followed the even more complex decision-making path that is typical of that country. The war against poverty had given rise to an intellectual ferment that could not fail to spill over into Canada. Social problems in the United States, such as racial strife, had become far more serious in the early sixties than anything found in Canada. The civil rights movement could not disregard economic and social rights. From 1963 to 1968 the Johnson administration established social programs on an unprecedented scale and, with typical U.S. optimism, it was believed that poverty could be completely rooted out.[37]

By the early 1970s, sustained postwar economic growth had led people

to believe in the physical possibility of solving the problem of poverty if only it were possible to design a system that was both generous and wise. The example of efforts made in the United States to deal with the problem were an additional incentive. The apparent possibility of devising a system that was "beyond ideologies" appeared to remove the political obstacles. A one-dimensional view of the solution to poverty, which had been conceived essentially as a deficiency of monetary income, appeared to be an acceptable price to pay to obtain the required consensus.

If all of these assumptions had been true, the reform would have taken place in spite of delays attributable to economic and political circumstances. Unfortunately the aspirations of the social planners were light years ahead of the political realities, as events were later to prove.

First of all, the ideal of non-discrimination toward various classes of social security recipients was not taken seriously enough to prevent, before as well as during the review process, the introduction of improvements in social allowances for specific classes. The increase in family allowances introduced in 1973, taking place at the very beginning of the process, was the result of federal-provincial interaction and not of an evaluation process that had not yet got under way. During 1974, the broadening of the old age security plan to make spouses aged 60 to 65 eligible, introduced a new source of disparity among recipients. One could add that the unemployment insurance reform, which preceded the social security review by two years and therefore completely escaped the general income security evaluation, restricted the latter even more closely. At the provincial level, social programs were also evolving.[38]

The meaning of all this is clear: an integrated income security program, as envisaged in the income security review, must be supported by a fundamental assumption: the equivalent "merit" of the various classes of recipients. During the 1970s at least, Canadians showed that they believed families with children, the unemployed and the elderly to be more meritorious than others. Once the needs of these classes of recipients were satisfied, the often objectively greater needs of the working poor and single-parent families did not appear to be of great importance in the eyes of public opinion. This objection to a comprehensive and truly non-discriminatory income security system remains valid today.

A final illustration of the fundamental nature and the strength of social preferences in the field of income redistribution is the decision in 1972 to index the personal income tax. This decision, seen ten years later, seemed clearly to be the greatest cause of the federal government's structural fiscal deficit: its cumulative financial impact was estimated by the Economic Council of Canada at six billion dollars for the 1979 fiscal year, much more than a guaranteed annual income plan would have cost. The way in which these two measures affect the various income classes is obviously completely different.

A Federal-Provincial Harmonization Mechanism Poorly Suited to the Intended Objective

But political reality contradicted the assumptions of the income security review in another way. A guaranteed income plan assumed that the design and management of a number of government programs would be integrated. The programs that absolutely must be coordinated with a guaranteed income plan include among others:

- *Unemployment Insurance.* In an integrated plan, a period of unemployment that leads a wage earner to fall below the zero allowance limit may lead to a double benefit: unemployment insurance and income security. On the other hand, the reintegration into the labour force of a formerly unemployed worker may, under these circumstances, lead to a "tax-back" rate of up to 100 percent. Moreover, if the guaranteed income program does not apply to the unemployed, there may be a number of anomalies vis-à-vis recipients who find themselves outside of the labour force. These problems can be solved on condition that at all times the programs in question be designed, modified and administered in relation to one another.
- *Manpower Training and Retraining.* The guaranteed income, particularly because of its reduction rate, which is under 100 percent, is likely to increase people's motivation to acquire training to increase their income. This assumes a considerable number of changes to plans whose primary purpose for at least some of its beneficiaries has been until now to supply immediate pecuniary benefits stemming from the difference between occupational training allowances and social assistance benefits.
- *Minimum Wage.* From a business standpoint, a guaranteed income plan may play the role of a manpower subsidy program. The factors that will determine the importance of this economic impact of a guaranteed income plan are to be found in collective bargaining agreements, level of unionization and perhaps especially the minimum wage level. The significance of the latter is not restricted to the hypothetical situation in which a guaranteed income plan has already been instituted, as indicated by T. Courchene:

  > Quebec has the highest minimum wage on the continent, let alone Canada. One of the reasons it is able to maintain this level is that much of the cost of such a policy is borne by other Canadians. Ottawa steps in with UIC payments and equalization payments as well as one-half the costs of welfare payments which arise from the high minimum wage.[39]

- *Taxation.* The mathematics of a guaranteed income program, i.e., the level of guaranteed income and the reduction rate, make it inevitable that income security benefits will be paid to people who fall largely

above the level of personal exemptions for personal income tax purposes. This paradoxically results in social allowances being paid to people considered able to pay taxes and an apparent waste involved when income transfers take place in opposite directions between the government and several million individuals. This problem may not be insoluble either, but a solution would require a close coordination in the development of the two policies or even complete integration, with the guaranteed income plan becoming a negative income tax.

In the 1973 to 1977 review, there was no question of including three of the four complementary areas described above. The review was set in motion by federal and provincial social affairs ministers, and none had a broad enough mandate to include these other questions. In fact, only a federal-provincial conference of first ministers would have been able to deal with the whole problem. It would appear that the political will to solve it simply did not exist at this level.

The global review of income security undertaken in Canada in the 1970s failed to meet its central objective, which was to establish a comprehensive guaranteed income plan. This failure cannot, I believe, be accounted for by circumstances outside the process, whether political or economic. More fundamentally, it was the objective itself that, while it was not repudiated, for it had never been the object of a true consensus, was abandoned; the absence of a political consensus became clear both through the adoption of other social measures that were given a higher priority and the isolation of sectoral ministers who, on their own, could not control a number of factors that were essential to a concept as ambitious as this one.

A final and necessarily hypothetical question needs to be considered. No one who has studied the income security review process from the federal-provincial standpoint has blamed intergovernmental considerations for the failure of the exercise. At the most, it has been suggested that the participants may have harmed the process by leaving the matter of the distribution of powers between the federal and provincial governments in this area until the end of the discussion. But the opposite is just as plausible.

One may nevertheless ask whether a federal-provincial agreement could have been reached on a question as vast as this and, if so, whether such an agreement would have been lasting. It is difficult to be optimistic about either question.

A guaranteed income plan differs from all existing social programs in that it affects a significant proportion of the labour force. Its beneficiaries find themselves in the centre of a conflict between the goal of social justice and that of economic efficiency. In a federation the separate exercise of sovereign power implies that different judgments may be made by the provinces and the federal government concerning the best

way of making these divergent objectives come together. It is difficult to imagine any agreements that would take precedence for long over such political judgments.

Conclusion

The first conclusion of this study is the following: of all the methods used to harmonize social policies, the spending power is the most important. It is obvious that the federal government's power to spend is the only method that has yielded results. Because of that power, the federal government has been the disseminator of innovation in the field of social policy; the first thing that was successfully harmonized was the date on which the main components of the health insurance plan came into force in the various provinces. The second aspect of the plan that was harmonized was the implementation of national standards of financial accessibility to the services in question.

For the future, this most effective instrument for the harmonization of social policies appears to be threatened primarily by the consequences of its past successes. Successive federal governments seem to be inclined to use it to the breaking point. The progressively widening use of national standards appears to reflect a willingness to adopt:

1. standards defining the program in question and the expenditures that may legitimately be made in connection with it;
2. standards determining who is entitled to benefits or payments from a given program and under what conditions; and
3. standards that determine a number of management practices for the programs in question.

Until recently, the spending power was used to institute standards in categories 1 and 2, and this was never contested. Recent efforts to institute standards for category 3 will probably lead to the first legal test of this federal power. At any rate it is difficult to imagine how a legal dispute on this matter could be avoided.

Another source of difficulty for the future use of the spending power stems from the precariousness of the arrangements that depend upon it. Unilateral changes in the federal government's contributions have made clear the lack of a true contractual basis to federal-provincial relations. Canada, like the other Western countries, has passed through a period of public sector growth that was propitious to the exercise of the spending power. For the present and the foreseeable future, the prospects are completely different, and this will certainly have consequences for intergovernmental arrangements: for those reasons it is quite possible that such arrangements might be rejected by the provinces in favour of a direct exercise of their own fiscal powers. By enshrining the "right" to equalization, the new Constitution makes such a possibility a virtual certainty.

In light of these considerations, it would appear that a number of changes will be necessary to preserve the federal government's spending power and hence its ability to take the initiative in harmonizing social policies. First, the "standards" that this authority brings into being must be restricted to categories 1 and 2. Third-category standards are clearly ultra vires, because they involve obvious federal regulation in an area defined as a provincial jurisdiction. The courts could be called upon to define the restriction more precisely.

Furthermore, a constitutional foundation should be established as a base for genuine federal-provincial agreements. Such agreements become virtually indispensable if the constant calling into question of financing programs involving both levels of government is to be avoided and to provide a basis for arbitration concerning interpretation problems. The formalism that would result from contractually binding agreements (prior legislative authorization or a posteriori ratification) would prevent their being used as they are today, for any short-term opportunistic purpose.

The creation of a constitutional basis for federal-provincial agreements requires a constitutional amendment. A definition of the spending power and a restriction on national standards in certain areas could take this form. A number of proposals for constitutional amendments have already been formulated by the federal government itself concerning its spending authority. In a federal white paper on federal-provincial grants and Parliament's spending power,[40] the prime minister proposed in 1969 that spending authority should not be used to create or change a program unless it was determined that there was a national consensus on the matter following a formula analogous to the one envisaged for amending the Constitution. Fortunately, this proposal was not agreed to at the time, or in 1982.

The advantage of the spending power is that it constitutes a power to initiate. If — rightly or wrongly — the federal government sees a need for harmonization, it can take the initiative in suggesting to the provinces a solution to any inconsistency or incompatibility among their respective policies. In order to be useful, this power to initiate must be capable of being exercised without a prior consensus; otherwise it will never be exercised in situations where the need for harmonization is greatest.

The danger of the spending power for the country's constitutional balances lies not so much in the unilateral character of the initiative in which it originates, but rather in the excessive scope that it might be given or in the ill-considered, or even frivolous uses to which it might be put. That is why restrictions are desirable in these two areas; the federal government should be given the ability to propose — with as few impediments as possible — adjustments that are likely to make the multiple objectives of the provinces and the federal government more compatible. However, these proposals should lead to long-lasting and trustworthy arrangements that create obligations for all parties and they should

be restricted to the elements that are necessary to harmonization without spilling over into other areas in such a way as to make harmonization nothing more than a pretext for centralization.

In the past, the use of unemployment insurance and old age security to solve problems of disparities in the labour force were in fact such a pretext for centralization. A clearer analysis of the true requirements for harmonizing social policies would have shown that the constitutional amendments of 1940 and 1951 were neither necessary nor really useful. Harmonized social policies were confused with uniform social policies. Although this was done in the name of economic efficiency, the result was that the Canadian economy probably suffered, and in any case, uniformity in income security policies for the elderly was not really achieved, nor was harmonization with the main social programs encouraged or facilitated. These two constitutional amendments show that harmonization is difficult to achieve by this means.

Quebec's attempt in 1971 to have provincial supremacy in social policies provided for in the Constitution is the only attempt so far to tie harmonization specifically to the Constitution. Since 1974, this constitutional idea has been illustrated in a practical fashion in provincial variations of federal family allowances. Since the law usually trails behind social developments, Quebec's proposal of 1971 was, in the context, a paradox. Income security is an area where the federal government predominates (it provides 85 percent of the financing), and under these circumstances provincial legislative supremacy would perhaps have offended common sense.

Nevertheless, from a broader perspective, the concept of provincial variation of federal programs is an idea that should be considered further, because it leads us to call into question other concepts that deserve criticism. In a way, equalization is an extreme example of a federal program modified by the provinces. Essentially, equalization and federal income security programs are very similar. Would it not be useful to examine the possibility of breaking down the airtight compartments into which the two have always been placed? The purpose of equalization is to provide all Canadians with equivalent public services and taxation levels: is this not — in another form — the same national standard for accessibility that is found in health insurance?

Apart from the accident of provincial variation of federal family allowances, the consensual approach to the harmonization of social policies in Canada has no accomplishment to its credit. The Canada Pension Plan and the Quebec Pension Plan are condemned to progress, like ocean-going convoys, at the speed of the slowest partner. In the context of a specific program — in this case a social insurance program — conservatism is perhaps an advantage.

However, when an attempt was made to coordinate the overall planning of income security, the net outcome was a failure. The failure was not the result of external circumstances: in a federal state, common

planning assumes a convergence of values and an identity, at a given moment, of preferences and priorities that would be surprising even in a centralized state. When planning is concerned, not with a clearly delimited sector or a specific program, but with a whole range of government activity, negotiations can take place only at the level of heads of government. When, moreover, the negotiations cannot achieve a formal contract and are exposed to sniping based on the political and electoral agenda of eleven different governments, it is to be expected that little will result, and that the risk of failure will be high.

The harmonization of social policies cannot result spontaneously from the identification of the need. In an international or federal context in which there are a number of sovereign powers, harmonization calls for a supranational or federal power. This power must be able to take the initiative in harmonization; to succeed, its efforts must not go beyond the objective needs of harmonization and must certainly not have a subversive influence on the general political balance of the union.

Notes

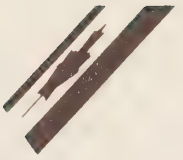
This study is a translation of the original French-language text which was completed in December 1984.

1. The complex relations between political institutions and the development of social policy was carefully explored by Keith G. Banting in *The Welfare State and Canadian Federalism* (Montreal: McGill-Queen's University Press, 1982).
2. For a complete description of these provincial programs, see Royal Commission on Health Services, *Report*, vol. 1 (Ottawa: Queen's Printer), pp. 383–421 (Hall Report).
3. Leslie Bella, "The Provincial Role in the Canadian Welfare State: The Influence of Provincial Social Policy Initiatives in the Design of the Canada Assistance Plan," *Canadian Public Administration* 22 (Fall 1979): 439–52.
4. Claude Morin, *Le pouvoir québécois . . . en négociations* (Montreal: Boréal Express, 1973). Claude Morin at the time was deputy minister of federal-provincial affairs; in 1970 he became minister of intergovernmental affairs. He naturally saw sinister designs in the fact that the 1966 federal plan included and appropriated ideas formulated in Quebec. Mr. Morin had been a member of the Study Commission on Public Assistance better known under the name of the "Boucher Commission."
5. Bella, *supra*, note 3, p. 447. The statement that CAP included no national standards must be qualified, because the program prohibited provinces from refusing assistance on the basis of the recipient's province of origin; moreover, each province was required to establish a procedure for appealing administrative welfare decisions. On these points, see Banting, *supra*, note 1, pp. 94–96.
6. The federal legislation did not grant each citizen a personal right in the strict sense. Only a provincial act could create such a right, and only three provinces did so (British Columbia, Manitoba and Quebec). It is also remarkable that the federal Act did not require the adoption of such an act by the provinces although the federal government's political intent was that they should do so, even though it didn't result in effective legal recourse for citizens.
7. *Supra*, note 2, pp. 57, 58. The claim that the federal government's intent to eliminate extra-billing and restrict deterrent fees is simply a return to the original concept underlying Canadian hospital insurance and health insurance programs makes the concept a poetic interpretation of the history of these programs. When Quebec attempted to prohibit extra-billing in the fall of 1970, a strike of specialist doctors

resulted and nobody seemed to think that the direction taken by the Quebec government had been imposed by the federal *Health Insurance Act* or by the federal Department of Health. The latter was very careful not to become involved in the affair. Royal Commission on Health Services, *Report*, volume 1 (Ottawa: Queen's Printer, 1964), p. 58.

8. This interpretation assumes that the courts tried to assign a meaning to section 36. This section is a matter of controversy among jurists. Andrée Lajoie believes that it is a declamatory clause expressing a vague statement with no real application: "At best it serves an ideological purpose" ("Education — The New Offensive by Spending Authorities," *Le Devoir*, March 6 and 7, 1984). For Justice Rémillard, on the other hand, it is "one of the most original and interesting provisions of the Canadian Constitution. . . . Ottawa's spending authority must be understood henceforth in this new context. Its scope is no longer the same. For public services, Ottawa will have to act through the equalization system and not through its spending authority" ("Ottawa cannot impose its national standards," *Le Devoir*, June 1, 1984). [translation]
9. Sections 91 (2A) and 94A.
10. Canada, Royal Commission on Relations between the Dominion and the Provinces, *Report*, vol. 2 (Ottawa: King's Printer, 1937), p. 42.
11. *Ibid.*, p. 37.
12. *Ibid.*
13. In 1950, 45 percent of all persons 70 years of age and over received full or partial pensions calculated on the basis of need. The new universal program granted pensions to the remaining 55 percent of those over 70 with higher incomes; hence the allusion to the median income in the text. It should nevertheless be pointed out that the median income was not a criterion for paying pensions before 1952.
14. Cited by Bora Laskin, *Canadian Constitutional Law*, 4th ed. (Toronto: Carswell, 1975), p. 638.
15. *Reference re Employment and Social Insurance Act* (1936), 3 D.L.R. 644.
16. *Supra*, note 10, p. 40.
17. This assessment of unemployment insurance in Canada was first stated by Thomas Courchene in "Interprovincial Migration and Economic Adjustment," *Canadian Journal of Economics* 3 (1970): 550–76. A more recent study confirmed its validity, Stanley S. Winer and Denis Gauthier, *Internal Migrations and Fiscal Structure* (Ottawa: Economic Council of Canada, 1982).
18. On this question in general, see Jean-Michel Cousineau's study, "Unemployment Insurance and Labour Market Adjustments," in *Income Distribution and Economic Security in Canada*, volume 1 of the research studies prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
19. K.C. Wheare, *Federal Government*, 4th ed. (London: Oxford University Press, 1957), p. 157: "The fact is that uniformity is not a popular conception in federal systems. Indeed one of the main objects of a federation is to avoid it."
20. Banting, *supra*, note 1, pp. 179–84.
21. For a succinct summary of this development, see A. Milton Moore, J. Harvey Perry and Donald Beach, *The Financing of Canadian Federation: The First 100 Years* (Toronto: Canadian Tax Foundation, 1966).
22. Statement by Marc Lalonde, Minister of National Health and Welfare, *Hansard*, June 6, 1975, p. 6521.
23. At the time of the 1964 agreements, section 94A was amended to include benefits to survivors and invalids without respect to age.
24. This conclusion is found in G. Rémillard, *La fédération canadienne: éléments constitutionnels de formation et d'évolution* (Quebec City: Éditions Québec-Amérique, 1980), pp. 150, 151.
25. Constitutional Conference, *Proceedings*, Victoria, British Columbia, June 14, 1971.
26. Sections 3 and 4 of the *Family Allowances Act*, 21–22, Elizabeth II.

27. Morin, *supra*, note 4, p. 22.
28. Banting, *supra*, note 1, pp. 165, 166, recalls that "The total silence on the question speaks volumes about the tolerance of Canadians for asymmetrical relationships as long as they are not raised to the level of principle."
29. Banting, ibid., p. 174.
30. Subsection 8(2) of the *Hospital Insurance and Diagnostic Services Act*, R.S.C. 1970, Chapter H-8, states that: "No regulation, by reference to which an agreement with a province has been made, shall be altered except with the consent of the province . . . ."
31. Andrée Lajoie, *Le contrat administratif : jalons pour une théorie* (Montreal: Éditions Thémis, 1984), pp. 142–83. I am grateful to Lajoie for a number of the items in the above analysis, but I am solely responsible for the conclusions.
32. Treasurer of Ontario, *Fiscal Federalism in Canada: The Record to Date, the Challenge Ahead*, Budget Paper B (Toronto: Ministry of Treasury, and Economics and Intergovernmental Affairs, 1981).
33. A. Johnson, *Federal-Provincial Financial Relations: A Very Personal Retrospect and Prospect*, paper presented at a conference of the Ontario Economic Council, Toronto, May 14, 1984 (photocopy).
34. K.G. Banting, "Federalism and Income Security: Historical Themes and Modern Variations," paper presented at a conference of the Ontario Economic Council, Toronto, May 1984 (photocopy).
35. See especially A.W. Johnson, "Canada's Social Security Review 1973–75: The Central Issues," *Canadian Public Policy* 1 (Fall 1975): 456–72; Rick van Loon, "Reforming Welfare in Canada," *Public Policy* 27 (Fall 1979): 470–504.
36. On this point, see: Economic Council of Canada, *Financing Confederation: Today and Tomorrow* (Ottawa: 1982), p. 8 and Table 1-3.
37. For a comparative analysis of reforms that failed in the United States and Canada, see Christopher Leman, *The Collapse of Welfare Reform: Political Institutions, Policy and the Poor in Canada and the United States* (Cambridge, Mass., M.I.T. Press, 1980).
38. We saw in the second section of the study that it was at the same time as the income security review was under way that a number of provinces established provincial supplements to the old age security programs of the federal government (see Table 3-2). To the social preferences for certain target populations should probably be added the preference of the various governments for the programs they alone control instead of the programs in which any changes depended on agreement. On this point Banting states that this "competition" was not in general an important factor in Canada, except perhaps between the federal government and Quebec during the period from 1960 to 1970 when the two governments were involved in a battle to establish their legitimacy in relation to one another.
39. T. Courchene, "Towards a Protected Society," *Canadian Journal of Economics* 13 (4) (November 1980), p. 574.
40. Canada, *Federal Provincial Grants and the Spending Power of Parliament*, Working Paper on the Constitution (Ottawa: Queen's Printer, 1969).



4

Taxation Policy and the Canadian Economic Union

ANTHONY F. SHEPPARD

Constitutional Framework, and Criteria for Tax Reform

In this research paper we shall examine the Canadian tax system and its impact on the economic union within Canada. The topic raises vast and difficult issues about which Canadian economists and political scientists have written extensively. The purpose of this paper is to contribute a legal perspective to public knowledge and understanding of these issues. A lawyer analyzes a problem by reference to decided cases and statutes, and in this paper we shall rely heavily upon these references with the object of reaching interested members of the general public who do not have any background in tax policy analysis. Therefore, to reduce the topic to manageable proportions, we shall inform the general reader about the legal context of tax policy analysis, apply that analysis to specific questions of current interest and advance some proposals for reform.

The paper is divided into three parts. First, in this section we shall briefly describe the constitutional provisions allocating the power of taxation between the federal and provincial governments and establishing the Canadian economic union. Also in this section we shall set forth the criteria for tax reform. Second, under the heading "An Appraisal of the Canadian Taxation System," we shall discuss various suggestions for reform. Finally, we shall briefly summarize the subject under the heading "Conclusions and Recommendations."

The Constitutional Framework

The primary sources of Canadian constitutional law are British and

Canadian statutes and decided cases. One of Britain's constitutional landmarks is a statute known as the *Bill of Rights, 1689*,[1] prohibiting the Crown from imposing a tax without the authority of an act of the central Parliament in London.[2] In a unitary state such as Great Britain, all legislative power rests with Parliament. As a result of the *Bill of Rights, 1689* in Britain, Parliament has complete sovereignty to tax anything or any person capable of being taxed,[3] in other words, to impose any conceivable form of taxation.

Although taxes appear in many forms, for constitutional purposes when we refer to taxation we mean a compulsory exaction enforceable by laws imposed by public authority for a public purpose.[4]

Canada is a Federal State

Canada did not follow the British model and, looking to the United States, adopted the federal system of government. The *British North America Act, 1867*[5] (renamed the *Constitution Act, 1867* by the *Constitution Act, 1982*,)[6] creates a central or federal Parliament and provincial legislatures and divides sovereignty between the two levels of government. Sovereignty means that each of these levels of government, within its area of legislative competence, exercises its power free from the control of the other.[7] By subject-matter, the act enumerates the federal and provincial functions and confers on the federal Parliament any function not allocated to the provinces.[8] Because the *Bill of Rights, 1689*[9] is part of Canada's Constitution, a valid tax requires legislative authority. To determine the validity of tax legislation, we must turn to the act which divides taxing powers between the federal Parliament and the provincial legislatures.

The Division of Taxing Powers

Subsection 91(3) of the *Constitution Act, 1867*, confers on the Canadian Parliament legislative competence over the following:

> 91(3). The Raising of Money by any Mode or System of Taxation.

This general power of taxation includes the exclusive right of the federal Parliament to impose two particular forms of tax, namely, customs and excise duties.[10] A customs duty is imposed on goods imported into or exported out of Canada.[11] An excise duty is "imposed at some step in the production or distribution [of goods] before they reach the hands of consumers."[12] In other words a tax on consumers, such as a retail sales tax, is not an excise duty.[13]

Section 92 of the act confers upon the provinces, to the exclusion of the federal government, the following powers to tax and to charge fees for revenue purposes:

92(2). Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes.
92(9). Shop, Saloon, Tavern, Auctioneer, and other Licences in order to the raising of a Revenue for Provincial, Local, or Municipal Purposes.

By subsections 92(8) and (9), the act subordinates the municipal level of government to the provincial legislature. A municipality derives its existence and powers from the legislature of the province in which the municipality is located. The courts have interpreted these subsections of the act as implicitly authorizing a province to delegate taxing power to its municipalities.[14] Since the municipality is subordinate, the province cannot delegate greater taxation power than the act confers upon it. Similarly, territorial governments derive their existence and taxing power from the Canadian Parliament.[15]

The Limits of the Federal Taxing Power

Although subsection 91(3) of the act appears unlimited, permitting the federal Parliament to raise money by any mode or system of taxation, the courts have held that subsection 92(2) implicitly fetters the federal taxing power by conferring upon the provinces exclusive authority to impose direct taxation within the province to raise money for provincial purposes. Reading subsections 91(3) and 92(2) together, the courts have held that the federal Parliament cannot levy a direct tax for provincial purposes since subsection 92(2) reserves that function exclusively to the provinces.[16] Whether the federal Parliament can levy an indirect tax for a provincial purpose is an open question which the courts have not finally decided.[17]

The Limits of the Provincial Taxing Power

Subsection 92(2) of the *Constitution Act, 1867* confines the provinces to imposing direct taxation within the province for provincial purposes. The courts have carefully defined the two limitations, "direct taxation" and "within the province." They have never explained the third limitation, "for provincial purposes."[18]

"Direct taxation" After many cases raising the question whether a tax is direct or indirect, the courts have developed a general approach to determining the issue. It usually arises because a disgruntled taxpayer contends that a provincial tax is indirect and beyond the power of the legislature. Dickson, J., for the Supreme Court of Canada, described the method of analyzing whether a tax is direct or indirect as follows:[19]

> Direct or indirect taxation —
> The appellant claims that the mineral income tax and the royalty surcharge are indirect taxes and hence beyond the power of a provincial legislature.

> The established guide for determining the validity of this submission is the classical formulation of John Stuart Mill (*Principles of Political Economy*, Book B, c. 3):
>
> > Taxes are either direct or indirect. A direct tax is one which is demanded from the very person who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another; such are the excise or customs.
> >
> > The producer or importer of a commodity is called upon to pay a tax on it not with the intention to levy a peculiar contribution upon him, but to tax through him the consumers of the commodity, from whom it is supposed that he will recover the amount by means of an advance in price.
>
> Mill's well-known writings appeared not long before the drafting of the *British North America Act, 1867* and were presumed by the Privy Council to be familiar to the Fathers of Confederation. The definition was first applied in *A.-G. Quebec v. Reed*.[20] In that case it was held that the question whether a tax is a direct or an indirect tax cannot depend upon special events which may vary in particular cases; the best general rule is to look to the time of payment and if at that time the incidence of the tax is uncertain then it cannot be called direct taxation. Mill's test became firmly established in *Bank of Toronto v. Lambe*.[21] In that case Lord Hobhouse said that while it was proper and, indeed, necessary to have regard to the opinion of economists, the question is a legal one, viz. what the words mean as used in the statute. The problem is primarily one of law rather than of refined economic analysis. The dividing line between a direct and an indirect tax is referable to and ascertainable by the "general tendencies of the tax and the common understanding of men as to those tendencies": *Lambe's* case.

In this passage, Dickson, J. points out that the incidence of tax for constitutional purposes is a legal question, so that whether a tax is direct or indirect depends upon its legal rather than its economic incidence. "Incidence" and "indirect" have different meanings for constitutional lawyers and economists. Throughout this paper, we should be aware that lawyers and economists analyze tax statutes for different purposes and from different disciplinary perspectives, using the same terminology with differing meanings. We shall note the different meanings as they appear.

"Within the province" The second limitation on the provincial taxing power under subsection 92(2) of the act is that a province can impose a tax only within its own geographical boundaries. The courts deal with this issue by identifying the subject matter of the tax and then locating it either inside or outside the province. A tax imposed on a person or thing outside the province is beyond provincial legislative competence. Lord Thankerton described the proper method of finding the subject matter as follows:[22]

> The identification of the subject-matter of the tax is naturally to be found in the charging section of the statute, and it will only be in the case of some ambiguity in the terms of the charging section that recourse to other sections is proper or necessary.

Provincial natural resource taxation In recent years, natural resource taxation has strained federal-provincial and interprovincial relations causing political and economic disunity.[23]

Until 1982, subsection 92(2) of the *Constitution Act, 1867* set forth the constitutional limits of provincial taxing powers over natural resources. Applying subsection 92(2) courts prohibited a province from taxing gross revenue or production from natural resources in the province because it is indirect excise taxation; to qualify as a direct tax, it must permit the taxpayer to deduct at least some costs of production in computing the tax base.[24] In 1975, a majority of the Supreme Court of Canada held in the *CIGOL* case[25] that a Saskatchewan tax on the windfall profits of oil production in the province was unconstitutional as indirect taxation and an infringement of the federal power to regulate trade and commerce. Dickson, J., dissenting, held that the tax was not only direct but also consistent with provincial ownership of the natural resources in the province:[26]

> The province of Saskatchewan had a bona fide legitimate and reasonable interest of its own to advance in enacting the legislation in question, as related to taxation and natural resources, out of all proportion to the burden, if there can be said to be burden, imposed on the Canadian free trade economic unit through the legislation.

In 1982, the *Constitution Act, 1867* was amended by the addition of subsection 92A(4), reversing the majority decision in the *CIGOL* case, and permitting the provinces to levy indirect excise and customs (export) taxes on non-renewable natural resources, forestry resources and electrical energy destined for interprovincial and international trade:

> 92A(4). In each province, the legislature may make laws in relation to the raising of money by any mode or system of taxation in respect of
>
> (a) non-renewable natural resources and forestry resources in the province and the primary production therefrom, and
> (b) sites and facilities in the province for the operation of electrical energy and the production therefrom,
>
> whether or not such production is exported in whole or in part from the province, but such laws may not authorize or provide for taxation that differentiates between production exported to another part of Canada and production not exported from the province.

Subsection 92A(4) authorizes the provinces to tax exports of natural resources, forestry and electrical energy production according to the "origin" principle,[27] meaning that a producing province must impose tax equally upon all its output of a particular commodity regardless of whether its intended destination is within the producing province, another province or a foreign country.

The Principal Taxes

Within these constitutional limits, Canadian governments presently impose the following taxes.[28]

Of course, the list is incomplete, but it sets forth the taxes with which this research paper is concerned.

Federal:
- Income tax
- Sales tax
- Customs and excise duties
- Oil and gas royalties and taxes

Provincial and territorial:
- Income taxes
- Retail sales taxes (except Alberta, Northwest Territories, Yukon Territory)
- Gift tax and succession duty (Quebec only)
- Mining taxes
- Natural resource royalties
- Corporate capital taxes (British Columbia, Manitoba, Newfoundland, Ontario, Quebec and Saskatchewan)

Municipal:
- Property taxes
- Business taxes

Canada is an Economic Union

The constitutional ideal of a Canadian economic union underlies many of the provisions in the *Constitution Act, 1867* and the *Canadian Charter of Rights and Freedoms*,[29] which was enacted in 1982 and is part of our Constitution. An eminent Canadian historian has written that the Founding Fathers envisioned an economic as well as a political union:[30]

> The central economic ambition of the Fathers of Confederation was to increase the production, to hasten the expansion and to promote the prosperity of the British North American provinces by the establishment of a new national economy. It was believed that the resources and industries of British North America were diversified and complementary: it was argued

that the integration of these various elements would provide the requisite basis of a stable economic life.

In this section of the paper, we are concerned with the federal and provincial taxation powers in the Constitution and their relationship to the constitutional ideal of economic union. Among the possible goals of the Canadian economic union we might tentatively list the free movement of goods, people, capital and enterprise throughout Canada and the attaining of equality of opportunity and economic benefits among individuals and regions throughout the country. Taking a legal approach, we shall examine the Constitution and the cases -- particularly those involving the taxing powers — to determine whether these ideals have a legal basis.

Free Movement of Goods

Subsection 92(2) of the *Constitution Act, 1867* helped to integrate the Canadian economy by limiting the provinces to imposing direct taxes, thereby prohibiting them from imposing indirect taxes on imports and exports at provincial borders.[31] Another important provision is section 121 of the *Constitution Act, 1867*, providing for free trade among the provinces:

> 121. All Articles of the Growth, Produce or Manufacture of any one of the Provinces shall, from and after the Union, be admitted free into each of the other Provinces.

Despite its broad wording, the courts have narrowly interpreted section 121 as prohibiting the provinces from erecting customs barriers to interprovincial trade. The courts have held that the section exempted interprovincial trade from provincial customs and excise duties but that it was not "free" from other forms of provincial taxes. Duff, J., a leading constitutional judge, said of section 121 "that the real object of the clause is to prohibit the establishment of customs duties affecting interprovincial trade in the products of any province of the Union."[32] In the same case, Mignault, J. explained section 121 as follows:[33]

> I think that . . . the object of section 121 was not to decree that all articles of the growth, produce or manufacture of any of the provinces should be admitted into the others, but merely to secure that they should be admitted "free", that is to say without any tax or duty imposed as a condition of their admission. The essential word here is "free" and what is prohibited is the levying of customs duties or other charges of a like nature in matters of interprovincial trade.

Since subsection 92(2) prohibited the provinces from imposing customs duties because they were indirect taxes, this interpretation of section 121 gave it little additional impact. The courts have often upheld the validity of a tax interfering with interprovincial trade on the ground that the tax

was in the form of a direct tax, different from a customs or excise duty, such as a retail sales[34] or tobacco tax[35] on goods imported into the province.

Before 1982, the courts readily struck down provincial export taxes as indirect customs and excise taxes and as the colourable regulation of trade and commerce.[36] However, the enactment of subsection 92A(4) now permits such taxes on natural resource production.

Section 121 has little application to the federal Parliament since the courts have said that it does not fetter the federal trade and commerce power under which the federal government can prohibit imports into a province.[37] Thus, section 121 does not prevent the federal government from erecting non-tax barriers to interprovincial trade.

Free Movement of Persons

Since Confederation, the opening up and settlement of Western and, more recently, Northern Canada have helped to integrate the Canadian economic union. The *Canadian Charter of Rights and Freedoms, 1982*, added to the Constitution rights of free movement of persons throughout Canada:

> 6(2). Every citizen of Canada and every person who has the status of a permanent resident of Canada has the right
> (a) to move to and take up residence in any province; and
> (b) to pursue the gaining of a livelihood in any province.

The Supreme Court of Canada has interpreted subsection 6(2) as creating two rights relating to the free movement of persons.[38] Paragraph 6(2)(a) creates the right to take up residence in another province. Paragraph 6(2)(b) confers the right to find employment or become self-employed in another province without taking up residence there. The Court said that paragraph 6(2)(b) concerns interprovincial movement of persons and does not create a right to work in the province where one resides.

Ever since Confederation, the courts have protected the freedom to move and work throughout the country unimpeded by tax barriers. In 1878, British Columbia passed *An Act to provide for the better collection of Provincial Taxes from Chinese*, requiring every Chinese person over 12 years of age in the province to pay a quarterly licence fee of $10 and every employer to pay $100 quarterly for each Chinese employee. Gray, J., of the British Columbia Supreme Court, held the tax invalid because it infringed on the federal legislative powers over aliens and trade and commerce.[39] Mr. Justice Gray criticized the tax as destructive of the Canadian economic union and federal sovereignty over international relations:[40]

> From the examination of its enacting clauses, it is plain that it was not intended to collect revenue, but to drive the Chinese from the country, thus

> interfering at once with the authority reserved to the Dominion Parliament as to the regulation of trade and commerce, the rights of aliens, and the treaties of the Empire. It interferes with the foreign as well as the internal trade of the country, and its practical effect would operate as an absolute prohibition of intercourse with the Chinese.

Then in 1884, the British Columbia Legislature enacted the *Chinese Regulation Act*, imposing an annual tax of $10 on every Chinese over 14 years of age. A taxpayer refused to pay the tax and, again, the Supreme Court of British Columbia struck it down as contrary to the exclusive federal legislative power over trade and commerce and aliens.[41] Crease, J. condemned the tax as creating a barrier to the free movement of immigrant labour through British Columbia to areas of Canada where jobs were available building the railroads, thus weakening the Canadian economic union by impeding not only migration but also the national transportation system.[42]

> It is a great assumption of power on the part of a Province to pass laws, the effect of which must be practically to expel a particular class of aliens from the Province, to say in effect that it will by its legislation impede or prevent that class from being employed in another Province — say the North-west Territory or Manitoba — where railway works may be languishing for want of that very class of labourers, British Columbia being the only seaboard of Canada on the Pacific through which . . . that class of labourers can enter and pass through [sic]; that is, in fact, legislating on interprovincial immigration; . . .

These two cases show the appreciation possessed by these 19th century judges that Canada's survival depended upon the development of a strong national economy. In both cases, they held that a province did not have the power to exclude unwanted persons from its borders by imposing a discriminatory tax. If such legislation were enacted today, it would violate subsection 6(2) of the *Canadian Charter of Rights and Freedoms*. Subsection 15(1) of the Charter (effective April 17, 1985),[43] could strike down such legislation as discriminatory based on race, national or ethnic origin.

Free Movement of Capital and Enterprise

The mobility of capital and enterprise throughout Canada has received some recognition in the constitutional cases. For constitutional purposes, taxing is different from regulating, and a province may not impose a tax as a disguised attempt to regulate the banking industry or other federally-regulated undertaking in the province.[44] Similarly, the constitutional doctrine that a province may not impair the "status and essential powers" of a federally-incorporated company might prevent a province from imposing discriminatory taxes against such a company doing business in the province, but there is a dearth of authority on the question.[45]

Equality of Opportunity

Equality of opportunity will soon become a recognized constitutional norm and may have implications for the Canadian economic union. Subsection 15(1) of the *Canadian Charter of Rights and Freedoms*,[46] effective April 17, 1985, will invalidate, with qualifications, federal or provincial legislation (including tax statutes) causing inequality before the law and discrimination. Subsection 15(1) provides as follows:

> Every individual is equal before and under the law and has the right to the equal protection and equal benefit of the law without discrimination and, in particular, without discrimination based on race, national or ethnic origin, colour, religion, sex, age, or mental or physical disability.

Subsection 15(2) will permit reverse discrimination to increase economic equality among individuals or groups:

> 15(2). Subsection (1) does not preclude any law, program or activity that has as its object the amelioration of conditions of disadvantaged individuals or groups including those that are disadvantaged because of race, national or ethnic origin, colour, religion, sex, age, or mental or physical disability.

Regional Equality

The Canadian economic union consists of economically diverse regions; some fortunate areas have abundant population, natural resources and investment capital. Other areas lack one or more of these important ingredients of economic prosperity. The federal and provincial governments have a constitutional obligation to relieve the less prosperous regions of the country and to reduce regional disparities. In a recent constitutional case, Laskin, C.J.C. said:[47] "attempted equalization of economic benefits throughout the country is a value that goes to the heart of a working federalism. . . ."

Even more important than this judicial dictum, subsection 36(1) of the *Canadian Charter of Rights and Freedoms* commits the federal and provincial governments to the goal of greater equality of opportunity to reduce individual and regional disparities. Subsection 36(1) provides as follows:

> 36(1). Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to
> (a) promoting equal opportunities for the well-being of Canadians;
> (b) furthering economic development and to reduce disparity in opportunities; and
> (c) providing essential public services of reasonable quality to all Canadians.

The Courts' Role

Although the courts have struck down provincial customs and excise duties that interfere with the free movement of goods and discriminatory taxes intended indirectly to prohibit people from living or working in a particular province, they generally have furthered provincial attempts to impose taxes impinging on interprovincial trade. The courts have often upheld the validity of a provincial tax despite the taxpayer's objection that the tax interfered with an enterprise important to the Canadian economic union, such as banking,[48] transportation[49] or telecommunication.[50]

As a general rule of statutory interpretation, the courts try to interpret a tax so as to minimize its adverse impact on the Canadian economic union.[51] If a tax is free from ambiguity, the courts are powerless even though they may consider that it hinders the economic union. As Lord Hobhouse said:[52]

> Whether this method of assessing a tax is sound or unsound, wise or unwise, is a point on which their Lordships have no opinion, and are not called on to form one, for as it does not carry the taxation out of the province it is for the Legislature and not for Courts of Law to judge of its expediency.

The Criteria for Tax Reform

Taxation Policy

Taxation reform generates a great deal of public discussion; magazines, newspapers, radio and television frequently contain criticisms of aspects of the Canadian tax system or proposals for change. The general public needs a clear understanding of the basic principles by which to judge such criticisms and proposals. Taxation policy is concerned with formulating the appropriate criteria or standards and applying them to particular policy questions. Drawn from the fundamental ideas of political science, economics and constitutional law, these criteria are the goals of a tax system.[53] In this section of the paper, we shall describe the most important goals or criteria of a good tax or tax system,[54] apply each of the criteria to current issues of taxation and the economic union, and rank the criteria in order of importance. The main criteria may be summarized as follows:

Criterion	*Policy Objective*
Adequacy	Tax revenues, in the long run, should balance the budget.
Practicality	Taxes should be simple, easy to administer and understand.

Equity	Each taxpayer should pay no more and no less then his or her fair share of the tax burden.
Redistribution of wealth	Taxes should improve the economic well-being of the poor.
Neutrality	Taxes should not interfere with the efficient and effective operation of the free market economy.
Economic stability	Taxes should encourage economic growth and discourage inflation.
Political order	Taxes should be enacted by open parliamentary democracy and administered without official abuse of the rights and freedoms of individual taxpayers. Taxes should not weaken federal-provincial relations.

Adequacy

To raise money, governments may command resources, create money, borrow, or impose taxes.[55] Usually, various combinations and forms of the last three methods are used. The adequacy criterion simply recognizes that, in determining whether to introduce a tax, the policy maker must compare its capacity to raise revenue with those of other methods such as borrowing or other forms of taxation. Similarly, in determining whether to change a tax, the impact of the prospective change on tax revenue should be considered. If the planner is considering whether to introduce or increase a deduction or exemption, the potential loss of tax revenue should be estimated.

The criterion also emphasizes the idea that a good tax system should yield the appropriate amount of revenue to balance the budget over time. If the system yields insufficient revenue, the government must either reduce expenses or enter into deficit financing. Conversely, if the tax system yields too much revenue, it may depress economic activity in the private sector and reduce investment. The current debates about government restraint and reducing the deficit at both federal and provincial levels show the difficulty and importance of this criterion.

The criterion has a well-established basis in constitutional law, where the dominant feature or pith and substance of a tax is raising revenue.[56] Subsections 91(3) and 92(2) of the *Constitution Act, 1867*, refer to the raising of money and the raising of a revenue as the proper purposes of federal and provincial taxation. Subsection 92(9) of the act also refers to the raising of a revenue as the proper purpose of a licence fee.[57] In

constitutional terminology, a so-called tax imposed for a legislative purpose other than raising revenue is a colourable attempt to regulate the activity bearing the tax.[58] The constitutional validity of a regulatory tax depends on whether the legislature could regulate the activity.[59] The British Columbia cases striking down taxes on Chinese are examples of regulatory taxes exceeding provincial powers. Customs duties may be enacted to raise revenue, to regulate foreign commerce or to accomplish both objectives.[60] If the federal government imposes a customs duty to raise revenue, a court would uphold its validity because subsection 91(3) of the act confers on it the power to levy an indirect tax such as a customs duty. Alternatively, a customs duty to protect domestic industries would fall within federal regulatory competence under subsection 91(2) of the act as trade and commerce.[61]

Applying the adequacy criterion to Canadian federalism, we can identify as chronic problems the provinces' inability to meet expenses from their own revenues and their dependence on federal financial assistance. Subsection 36(2) of the *Canadian Charter of Rights and Freedoms* states the federal responsibility to offset this perpetual inadequacy as follows:

> 36(2). Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

These problems began in 1867 when the Fathers of Confederation allocated the taxing powers between the national and provincial governments, intending to match their respective revenues and spending responsibilities so that each level of government would be financially independent. They expected the provinces to pay their expenses by borrowing, and from three other sources provided for by the act.[62] A primary source of provincial funds would be an annual subsidy paid by the Dominion of Canada to the provinces according to their respective populations.[63] As an equally important revenue source, the act allocated to each province public lands within its boundaries.[64] Section 125 of the act protected that source from encroachment by taxation:

> 125. No Lands or Property belonging to Canada or any Province shall be liable to taxation.

Recently, Martland, J., of the Supreme Court of Canada, explained the historical reason for section 125:[65]

> Section 125 . . . protected the lands and property of one level of government from incursion by way of taxation by the other level of government. . . . Faced with the general constitutional taxing competence of the federal parliament under s.91(3) of the Act it was important for the survival

> of the provinces and of Canadian federalism that this vital source of provincial revenue be protected from erosion through taxation. Section 125 thus gives legislative recognition to that constitutional value.

Finally, the provinces were expected to resort to direct taxes (subsection 92(2)) and licensing fees (subsection 92(9)) merely to supplement temporary shortages in the first two sources:[66]

> These revenue sources [direct taxes and licence fees] were not expected to yield significant sums of money; indeed, the extreme unpopularity of direct taxes in this era of "laissez-faire" political theory created the assumption that the provinces would levy taxes only as a last resort: . . .

Since Confederation, provincial expenditures on matters such as public health, education and social welfare have drastically exceeded these sources of revenue. The chronic shortage of funds weakens provincial governments, makes them dependent upon the federal government for financial aid and can destroy provincial sovereignty on which federalism is based. The difficulty of dividing revenue sources between federal and provincial governments so as to make them financially self-sufficient is "one of the chief obstacles to the proper working of federalism in modern conditions."[67]

To relieve this federal-provincial fiscal imbalance, Canada has used three main techniques. First, the federal government gives the provinces financial assistance in the form of cash payments, grants and loans. Second, the federal government can create "tax room"; where the federal and provincial governments share a common form of taxation such as the income tax, the federal government can reduce its share of the revenue by lowering its rates, thereby allowing the provinces to raise their rates without adding to the tax burdens of the taxpayer. Third, an amendment to the *Constitution Act, 1867* can increase provincial taxing power: an example was the enactment of subsection 92A(4).

There are limits to these techniques. The federal government's own mounting deficit impairs its capacity to increase financial assistance or "tax room" to the provinces.[68] Similarly, taxpayers seem to have reached the point at which they will balk at further tax increases, so that if enhancing provincial taxing power means heavier taxation it would be not only potentially harmful to a weak economy but also very unpopular.

Nevertheless, the federal Department of Finance,[69] a Royal Commission,[70] and at least one constitutional expert[71] have recommended that the Constitution should empower the provinces to impose indirect taxes. After these recommendations were made, the enactment of subsection 92A(4) and the declining economy took away at least some of their force. Is the provinces' inability to levy indirect taxes other than on natural resources a serious impediment to fiscal self-sufficiency? The answer to this question is beyond the scope of this paper.[72] However, if the provinces were given further powers to impose indirect taxes, section 121 might need to be expanded to protect the economic union.[73]

Practicality

The criterion of practicality points to several related qualities of a tax or tax system. Classical economists required certainty as to the time, manner and amount of payment of tax. Recently, the Federal Court of Appeal struck down a tax because the time of payment was uncertain.[74] Usually, uncertainty does not have such drastic consequences; it merely annoys or inconveniences taxpayers and administrators. Doubt about the impact of the present law or whether proposals for change will be implemented can delay taxpayers in making business or investment decisions. The slow federal legislative process of enacting tax changes has left taxpayers and public officials at sea for months or even years.

Simplicity is "universally sought after"[75] as a quality of a specific tax or tax system.

Efficiency in collection is also desirable; the government's administrative costs in collecting each dollar of tax revenue and the taxpayer's compliance costs in time, money and effort spent in paying the tax should be small.[76]

To improve tax collection, the courts should try to avoid interpreting a taxing statute so as to create opportunities for fraud and other abuses by tax collectors[77] or wholesale avoidance by the intended taxpayers.[78] The courts should, if possible, avoid an interpretation that renders a tax statute unworkable or absurd.[79]

In a federal tax system, the practicality criterion tends to prefer tax changes enhancing centralization at the federal level and to oppose any province wishing to go its own way in a taxation matter.[80]

According to the practicality criterion, tax policy formulation, tax collection and administration should perhaps be centralized in the federal government. In theory, the federal government is in a better position than the provinces to develop consistent policies for the whole country.[81] A federal government insensitive to regional variations in developing such policies will ultimately face the voters' harsh judgment at the polls. In the administration and collection of a tax for the whole country, the federal government can take better advantage of economies of scale to minimize bureaucratic costs. Finally, a centralized tax system should minimize taxpayers' compliance costs; there should be fewer tax forms to complete and tax rules to master. In this era of government restraint, practicality assumes even greater importance, suggesting that the provinces should avoid the unnecessary expense of duplicating federal tax collection systems.

For example, the federal government will provide the necessary services to administer and collect income tax on behalf of any province adopting the federal rules for computing taxable income.[82] For the collection of corporate income tax, all of the provinces except Ontario, Quebec and Alberta have made collection agreements with the federal government. For the collection of personal income tax, all of the provinces except Quebec have made similar agreements. Agreeing provinces

do not have to pay the federal government for this service. Considering the additional costs, the Ontario Economic Council felt that Ontario should not withdraw from the tax collection agreement and institute its own collection system for personal income tax.[83] Yet, in 1984, the Province of Alberta announced as a "possible initiative" the implementation of its own personal tax system.[84] The proposal summarily deals with the practicality criterion only by suggesting that the "utilization of the most modern computer and information technology" will lower administrative costs and manpower requirements.[85] Surely this does not begin to satisfy the demands of the practicality criterion.

In a federal state such as Canada, provincial sovereignty and practicality are generally considered to be at odds, but there is another point of view. Several leading Canadian economists have used the practicality criterion to defend federalism and provincial sovereignty, and have argued that centralization imposes heavy economic costs on both the government and the public.[86]

Equity

A tax or tax system should fairly and equitably spread the burden over the range of prospective taxpayers. While everyone shares the ideal of equity, it is a difficult concept to define or measure.[87] Some early Canadian cases adopted equity as a constitutional requirement of a valid federal or provincial tax,[88] but since 1895 the courts have rejected it.[89] To have continued with such a standard of constitutional validity would have infringed on the parliamentary supremacy of the sovereign levels of government. In that year, Sir Henry Strong, C.J.C. said:[90]

> The objection of want of uniformity which was so strongly pressed is no legal objection. Granting that the legislatures have the power of imposing such taxes it is for them to say how it is to be distributed.

In the same case, Taschereau, J. said:[91]

> The contention of the appellant based on the ground that this tax has not been legally apportioned, and is null for want of uniformity and equality, is, in my opinion, untenable. Whatever political economists and other writers may say on this subject I know of no law in the Dominion that in any way puts any restriction, limitation or regulation of that kind on the powers of the federal and provincial authorities in relation to taxation within their respective spheres.

The new subsection 15(1) of the *Canadian Charter of Rights and Freedoms* will restrict this aspect of Parliamentary supremacy by requiring equal and non-discriminatory legislation, including taxing statutes.

The municipal level of Canadian government derives its subordinate taxing powers from a provincial legislature, so that parliamentary supremacy does not apply to municipal tax by-laws, and the courts will strike them down if they violate the equity criterion.[92]

Some courts may exceptionally apply equity standards to interpret an ambiguous tax statute.[93] Where a taxing statute is unambiguous, a taxpayer will not persuade a court to alter its literal interpretation on the ground that it is inequitable:[94]

> . . . as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be.

The literal rather than the equitable interpretation of taxing statutes is the general rule.

To the policy maker, the equity of a tax or tax system is often its most important single criterion.[95]

Public finance theory divides equity into two dimensions: horizontal equity, meaning that taxpayers in the same situation should be treated the same; and vertical equity, that those in different circumstances should be treated differently, according to their respective circumstances. To determine whether taxpayers are in the same or different circumstances, public finance theory provides two standards of measurement.

First, according to the benefit standard, the tax burden imposed on each taxpayer should relate to the benefit that person receives in the form of goods and services provided by government. Some courts have mentioned this standard of equity. Lord Sumner, on behalf of the Privy Council, approved of the benefit theory as a policy goal but not as a constitutional standard:[96]

> All rates and taxes are supposed to be expended for the benefit of those who pay them and some really are so, but the essence of taxation is that it is imposed by superior authority without the taxpayer's consent, except in so far as representative government operates by the consent of the governed.

In a provincial income tax case, Taylor, J., of the Saskatchewan King's Bench, perhaps exceeded the judicial function and ranged too far into tax policy when he dismissed a corporation's objection to an assessment with the following invocation of the benefit standard:[97]

> And I may be pardoned for pointing out that this province largely maintains the governmental and social institutions which enable the company to do . . . business in Saskatchewan. Other firms in competition with the appellant's business have to pay towards the upkeep of these social and governmental institutions, and it ill becomes any corporation taking advantage of a market for their products to contend that they should not pay the same share of taxation as other companies in like business in that market.

Reflecting the benefit theory of equity, that one should pay for what he or

she gets, governments finance some goods and services by user charges, meaning that a member of the public must pay a fee or price for a benefit provided by government. Whether a particular import is a tax or a user fee can be a difficult question for economists and lawyers. Recently Dickson, J., of the Supreme Court of Canada, suggested that if the amount of the price or fee related generally to the government's cost of providing the good or service, it was a user charge; but if the fee or price was "significantly greater" than its cost to government, the levy was a tax.[98] In other words, adequacy was the proper criterion to differentiate between user charges which merely defray expenses and taxes which raise revenue.

The other standard of measuring equity proceeds from the premise that taxpayers sacrifice their private well-being to pay taxes so that each taxpayer's sacrifice should be equal. According to this approach, taxpayers' well-being in monetary terms is their ability to pay. Horizontal equity requires that taxpayers with the same ability to pay should in general pay the same taxes. Vertical equity requires that a taxpayer with greater ability to pay should pay more taxes than one less capable of paying. A measure of ability to pay is income; the courts have recognized that the sacrifice standard of equity supports in principle the fairness of an income tax.[99]

Before 1972, Canada did not tax capital gains. In the public debate over whether capital gains ought to be taxed, the federal government invoked as its two main policy arguments, equity and practicality.[100] Invoking equity, the government said that "the well-to-do receive a much higher proportion of their purchasing power — their ability to pay — from capital gains than do those with lower incomes."[101] The government also felt that the taxation of capital gains would satisfy the practicality criterion by reducing income tax avoidance and uncertainty.[102]

In 1972, there was a consensus in favour of the tax, [103] but since then criticisms have mounted. For example, in 1978, the Royal Commission on Corporate Concentration concluded that the tax had encouraged concentration in Canadian industry and, to encourage small business, recommended abolition of the tax.[104] In 1984, the province of Alberta criticized the tax as complex and a deterrent to new jobs.[105]

In 1980, the federal Department of Finance defended the tax, arguing that it should be retained.[106] Since then, the federal government has amended the tax to blunt some criticisms. The deductibility of capital losses was expanded to meet the criticism that gains were unfairly taxed while deduction of losses was disallowed. Similarly, a scheme called an indexed securities investment plan (ISIP) now permits a taxpayer to pay tax only on real (non-inflationary) gains on corporate securities. By introducing ISIPs the federal government attempted to meet two criticisms: first, that the tax violated the equity criterion by catching illusory

or inflationary gains and second, that it deterred investment in Canadian companies. Further, the government restricted the principal residence exemption to meet criticisms that the exemption had violated equity, adequacy and practicality. Before 1982, the exemption permitted a married couple to claim two principal residences and was extremely favourable to the rich. By exempting capital gains on the disposition of one of the most important and common capital assets, the family home, the principal residence exemption drastically reduces the revenue yield of the tax, thus violating the adequacy criterion. Finally, the exemption violates practicality, inviting abuses by both taxpayers and public officials attempting to administer it. Other amendments to the capital gains provisions of the *Income Tax Act* have attempted to block tax avoidance devices in the corporate area and to reduce the tax burden on farms and small businesses.

In the result, the capital gains tax has become complex and perhaps an embarrassment to some of its former adherents. If we seriously want to simplify the tax laws and create an attractive environment for foreign and domestic investment capital, curtailment or repeal of the capital gains tax deserves a high priority for thorough consideration. However, equity, adequacy, and the next criterion, redistribution of wealth, strongly support a capital gains tax. Therefore, reform might be preferable to repeal, but the capital gains tax cannot endure much more of the complex reform it has recently received.

Redistribution of Wealth

Taxes and public expenditures, separately and jointly, can redistribute wealth among richer taxpayers and regions and poorer ones. To the policy maker, a good tax or tax system has the capacity to redistribute wealth among individuals and regions.

To achieve redistribution of wealth among individuals independently of public expenditures, a tax or tax system must be progressive, meaning that the burden must fall more heavily on the rich and more lightly on the poor than would be necessary to satisfy vertical equity. For example, a personal income tax is progressive in the sense that tax rates rise with income levels. A flat rate income tax would be proportional rather than progressive; that is, the rate is the same at all income levels, satisfying the vertical equity criterion but not redistribution. A regressive tax fails both criteria because its rates fall as taxpayers' abilities to pay rise to higher levels.

Judicial attitudes to redistribution as a goal of tax policy have changed over the years. In 1933, the Privy Council would say only that redistribution could be an element of a valid tax.[107] By 1982, in the words of Laskin, C.J.C., which we have already quoted, equalization of economic benefits went to the heart of a working federalism.[108] In the tumultuous 50 years between the two judicial dicta, redistribution had risen from an

inconsequential objective of a tax to a fundamental constitutional value. Even more authoritative, as we have seen,[109] the *Canadian Charter of Rights and Freedoms*, sections 15 and 36, explicitly endorses the redistribution of wealth as a constitutional norm.

Since the Canadian tax system comprises many federal, provincial and municipal taxes, we should consider whether the overall effect is progressive, proportional or regressive. Apparently, the system as a whole violates the redistribution of wealth criterion, for it is only proportional.[110] Moreover, the trend in recent years has been toward a regressive shifting of the tax burden from the wealthiest taxpayers to the middle-income earners.[111]

The guaranteed annual income (GAI) or negative (reverse) income tax generated considerable support not so long ago as a reform which would not only improve the redistributive effect of the income tax but also rationalize equalization among the provinces and social welfare programs.[112] Under a negative income tax, a single form, the annual income tax return, would provide the basis for determining whether one was liable to pay tax or entitled to receive income benefits. Politicians of socialist[113] and free enterprise[114] points of view recommended the guaranteed annual income during that era. GAI created so many practical problems and would have been so expensive that it was never implemented.[115]

Although GAI retains a certain theoretical appeal, the adequacy criterion suggests that revenue raising is at least as important as redistribution of wealth.

The GAI tried to combine the collection and distribution of income in one scheme and failed. Perhaps as a result of this failure the redistribution of wealth criterion has lost ground in recent years. The intervening changes to the tax system have been regressive, as we noted. This trend should at least be stopped, if not reversed, as it contradicts the spirit of the *Canadian Charter of Rights and Freedoms* by promoting greater economic inequality and regional disparity.

Neutrality

To the policy maker, a good tax promotes the efficient allocation of resources through the market economy, inhibiting misallocation and waste. Exponents of the neutrality criterion believe that individuals will save or spend in their best interests and that businesses will maximize productivity if the tax system does not distort their choices either by influencing prices or by altering the after-tax return from different forms of activity or investment. A tax that impartially leaves the allocation of resources to free market forces is neutral. According to this criterion, the tax system and its components should generally be neutral but where the free market mechanisms misallocate resources and if other policy instruments should fail, the policy maker might try to correct the market

distortion by imposing a non-neutral tax without infringing the criterion. Beyond this, the staunch neutrality adherent would disapprove of the use of the tax system as a policy instrument. Similarly, when business and investment decisions are made for tax rather than economic reasons, the tax violates neutrality.

When we examined adequacy, we saw that a regulatory tax failed the criterion because it provided little revenue to the government. A regulatory tax also infringes neutrality. The courts use the neutrality criterion to identify a regulatory tax. Recently, the Supreme Court of Canada had to determine whether a windfall tax on exported natural gas, introduced as part of the National Energy Program, 1980, was regulatory.[116] The problem arose because the tax applied to all exporters, including the province of Alberta, which claimed that section 125 of the *Constitution Act, 1867* exempted it. The courts had previously interpreted section 125 as exempting provincial governments from revenue-raising taxes, but not from regulatory ones. The federal government argued that the windfall tax was intended to regulate exports and foreign trade in gas, so that section 125 did not exempt the province. The majority of the Supreme Court held that the tax was introduced to raise revenue and that section 125 exempted the province. Martland, J., for the majority of the Supreme Court, applied the neutrality criterion in deciding whether the tax was regulatory:[117]

> *The Shorter Oxford English Dictionary*, 3rd ed., (1944) (revised with corrections 1973) defines "to regulate" as "To control, govern, or direct by rule or regulations; to subject to guidance or restrictions. . . . To adjust, in respect of time, quantity, etc., with reference to some standard or purpose". In relation to "regulation of trade and commerce", this definition and common sense would suggest a restraint upon or channelling of economic behaviour in pursuit of policy goals. The proposed tax in this case, when viewed in light of other legislation touching the natural gas industry, has no such regulatory effect on behaviour. By its very comprehensiveness, the tax belies any purpose of modifying or directing the allocation of gas to particular markets. Nor does the tax purport to regulate who distributes gas, how the distribution may occur, or where the transactions may occur.
>
> It might be said that in a free market, a general tax touching all natural gas would either lead to an increase in the price charged for gas, or, if that is impossible a shifting of money and effort out of a less profitable natural gas production industry into other industries. In a word, either the consumption or production of natural gas could be discouraged. There could be valid policy reasons for such discouragement, and excise taxes have often been justified on bases apart from revenue generation: . . .[118]
>
> The application of differential rates of taxation, for example, might reveal a regulatory or directive purpose. Yet in the present case, no such purpose or justification is advanced. Nor has the federal government expressed any desire to create disincentives to gas production or distribution. The proposed tax was not argued to be a conservation measure.

In short, the majority of the court felt that the tax was neutral and did not interfere with the free market allocation of resources. Obviously, Martland, J.'s concept of neutrality for constitutional purposes is different from that of an economist who might note the characteristics on which Martland, J. relied and reach the opposite conclusion: that a windfall tax on natural gas exports discriminated against that form of economic activity. In any event, neutrality is an established guide to the constitutional validity of a tax.

In the quotation, Martland, J. made a passing comment to the effect that "valid policy reasons" may justify tax measures intentionally designed not to raise revenue but to interfere with the market system. As a constitutional norm, Martland, J.'s dictum is correct. As a matter of tax policy analysis, his dictum should be viewed cautiously, if not skeptically.[119] When the economy is in difficulty, governments are tempted to try to promote economic growth and new jobs through tax incentives. Why should governments generally resist appeals for specific tax measures to achieve economic objectives?

First, tax incentives favour everyone qualifying for the relief, even those who would have done the tax-favoured thing had there been no such incentive. Second, the public often cannot accurately determine whether the economic benefit produced by the incentive has exceeded its costs, that is, the lost tax revenue. Third, taxpayers try to exploit tax incentives by using them for purposes unforeseen by the legislature, the prevention of which the government attempts by introducing hard-line administration and complex amendments and, if these fail, by repeal of the abused provision. Fourth, repealing tax incentives, even those no longer serving a useful economic purpose, is often extremely difficult, for repeal can disrupt businesses and investments. Fifth, in a free market economy, tax incentives favour some taxpayers at the expense of others, putting the latter at an unfair disadvantage and tempting them fraudulently to evade their tax burden. Sixth, tax incentives seldom achieve their economic objectives. For these reasons, tax policy analysts prefer the use of government grants and subsidies, rather than tax incentives, to attempt economic objectives.[120]

For example, the federal and British Columbia governments have expressed interest in creating "special economic zones" to stimulate growth. While the exact nature of these zones has not been indicated, they probably would be small, economically depressed enclaves designated by government, in which qualifying businesses would enjoy the competitive advantages of reduced taxes and regulatory requirements. The danger of such a tax incentive, as appears to have been the British experience, is that the formation of such zones would cause existing businesses to relocate therein and to compete on advantageous terms with rivals located elsewhere, causing the movement of existing jobs

from parts of the province and country to the zone, not the creation of new jobs, and a loss of tax revenue.

Throughout the world many nations, rich and poor, vie with each other to attract foreign trading and manufacturing operations by offering tax and other advantages to international enterprises willing to locate their operations in tax-free trade zones.[121] In Britain and the United States, attempts have been made to adapt the zone concept to urban renewal, thus encouraging new businesses to locate in decaying inner city slums.[122] Urban decay is not a serious problem in British Columbia, and other jurisdictions offer British Columbia little to go on in developing the zone concept to meet its unique economic problems.[123] Thus the general presumption against tax incentives seems applicable to the "special economic zones."

Economic Stability

Since the late 1960s the Canadian economy has suffered from unemployment, inflation, declining value of the Canadian dollar and balance of payment deficits, despite the efforts of the federal and provincial governments to stabilize their respective economies. Under the *Constitution Act, 1867*, the federal government has exclusive control over the levers of monetary policy, and both levels of government have concurrent legislative powers over fiscal, prices and incomes policies.

In a federal state, the control of policy is divided among different levels of government that can pursue conflicting goals, cancelling out the others' efforts and weakening management of the economy. Because Canada is an economic union, interprovincial trade tightly integrates the provincial economies into one national economy. These links with other provinces, called externalities by economists, limit each provincial government's control over its local economy. Because of these externalities, economists disagree about the extent of a province's fiscal power to stabilize its economy against recessionary or inflationary forces in other parts of the country.

To coordinate economic policy and to centralize decision making in the level of government having real power over the economy, economists used to argue that the federal government must have primary if not exclusive responsibility for managing the economy, but the prevailing view nowadays is that the provinces should participate in stabilizing their economies.[124] The legal argument against centralization is that increasing federal power over the economy would diminish provincial sovereignty, the cornerstone of Canadian federalism.

In 1976, the Supreme Court of Canada faced this issue in the *Anti-Inflation Act Reference*.[125] In 1975, the federal Parliament passed the *Anti-Inflation Act*[126] restraining profit margins, prices, dividends, salaries, wages and the like. In supporting the validity of the act, the

Attorney General of Canada argued, alternatively, that the federal government had the constitutional power to legislate on a matter of (1) national crisis and emergency or (2) national concern or (3) national dimension. The emergency argument reasoned that the Canadian Constitution would permit the federal government to centralize management of the economy only temporarily, and in exceptional circumstances, to combat a specific emergency. A majority of the Court accepted this argument, but rejected the broader argument based on national concern because, in the words of Beetz, J.:[127]

> It is not difficult to speculate where this line of reasoning would lead: a fundamental feature of the Constitution, its federal nature, the distribution of power between Parliament and the Provincial Legislatures, would disappear not gradually but rapidly.

The decision points out a constitutional obstacle to more effective management of the Canadian economy. Policy planners at the provincial as well as the federal level continue to have autonomous, sovereign responsibilities for managing the Canadian economy within their respective spheres and should have regard to the criterion of economic stability in formulating taxation policy.

A tax which meets the stability criterion has the capacity to reduce inflation in good times, and during recessionary periods to stimulate economic growth. When the revenue yielded by a tax automatically rises in good times and falls in bad, the tax is called an automatic stabilizer. Other taxes meeting the criterion are flexible enough that their rates can be raised or lowered to help level out fluctuations in the economy.

During a period of economic instability, such as a war or economic depression, the Canadian government has introduced a new tax as a temporary measure to meet the crisis but the tax has become permanent.[128] In Canada, World War I was the cause of a "temporary" income tax (1917)[129] and sales tax (1915).[130] In the present economic recession, the huge federal deficit may tempt the government to introduce a new indirect tax which would perhaps take the form either of a value-added tax (VAT) or a retail sales tax (RST).

At the present time the federal government does not impose an RST, though all the provinces, with the exception of Alberta, do so on goods and some services purchased in or brought into the province for consumption. The federal government imposes excise taxes,[131] which, as we have seen, are taxes on products before they reach the hands of a retailer or consumer. Federal sales and excise taxes may briefly be listed as: (1) the manufacturers' sales tax[132] — imposed on manufacturers, wholesalers and importers relating to all goods manufactured or produced in Canada, or imported into Canada (unless exempted), based on the manufacturer's selling price and the wholesaler's cost or, for

imported goods, the duty-paid value; and (2) excise taxes[133] — imposed on domestic and imported goods such as various forms of tobacco and alcohol, luxuries, large passenger cars and automobile air conditioners, gasoline for personal use and aviation fuel.

A VAT is a multi-stage sales tax.[134] A business enterprise usually purchases raw materials from its suppliers and, by processing, manufacturing or "adding value" in some other way, produces goods or services from the initial materials. A VAT would be levied on the amount of value added at each stage in the production, distribution or importation of the goods or services, usually including the retail step, by which they reach the consumer. Since the retail price of a product equals the total of the values added, a VAT including the retail stage is equivalent to an RST, the only difference being that an RST is collected only once, at the retail stage, and a VAT is collected at several stages.[135]

In Canada there has been little enthusiasm for a VAT but the proposed federal RST has received a warmer reception. In 1967 the Carter Commission recommended that the federal government abolish the manufacturers' sales tax and replace it with an RST but that if the problem of administrative control of the RST became too great, the federal government should adopt the VAT.[136] Instead of proceeding with Carter's recommendation, the federal government in 1982 attempted to move the manufacturers' sales tax to the wholesaler stage, thereby bringing it a step closer to a retail tax. The federal government did not, however, implement its proposal and instead appointed a committee to review the policy options. The committee disapproved of the government's proposal and endorsed Carter's proposed federal RST.[137]

Although the question is fraught with controversy, forceful policy considerations suggest that the federal government should not proceed with either a VAT or an RST. Each tax may have its own merits, but both may be criticized as inflationary, inequitable, regressive, complex and an invasion of an important provincial revenue source.[138] The taxes would cause at least a one-time price level increase by the rate of tax and might set off claims by workers for higher wages to maintain their purchasing power, in either event violating economic stability.[139] The taxes violate the equity criterion because the burden falls more heavily on lower income taxpayers who consume a higher proportion of their income than do their higher income counterparts who are able to save and invest.[140] Similarly, the taxes would violate the redistribution of wealth criterion because younger families and the retired and elderly who are often not savers would bear a heavier burden relative to their incomes.[141] Both the RST and VAT impose heavy administrative burdens on the business community, violating practicality, but the VAT's compliance costs are "staggering."[142] Since deficit problems exist at both the federal and provincial levels of government, the introduction of a

federal VAT or RST would make increases in provincial RSTs more difficult and reductions more probable, violating adequacy at the provincial level. Finally, the introduction of either tax would probably exacerbate federal-provincial relations, violating our last criterion, political order, to which we now turn our attention.

Political Order

This criterion emphasizes that a tax or tax system should meet legal and democratic standards. A tax must be valid under the *Constitution Act, 1867* and conform to the requirements of the *Canadian Charter of Rights and Freedoms*.[143] Few would disagree with the Carter Commission's statement that the objectives of tax legislation include protecting the liberties and rights of the individual and strengthening the Canadian federation.[144]

In the *Amax Potash*[145] case, the Supreme Court of Canada affirmed this criterion and struck down Saskatchewan legislation. In 1974, Saskatchewan introduced a potash prorating scheme including a tax on reserves of potash. Amax, a potash producer, brought an action for a declaration that the tax was beyond provincial legislative competence as an indirect tax and for a refund of taxes paid under protest. The province argued that even if the legislation were invalid, the *Proceedings Against the Crown Act* (Sask.), exempting the province from liability for any occurrence under an invalid act, protected the provincial treasury against claims for refunds. The Supreme Court of Canada rejected the argument, holding unconstitutional the *Proceedings Against the Crown Act*. Dickson, J. said:[146]

> If a state [province] cannot take by unconstitutional means it cannot retain by unconstitutional means.

Subsequently, the Supreme Court of Canada declared that the potash prorating scheme including the tax was beyond provincial legislative competence.[147] Laskin, C.J.C., for the court, affirmed the political order criterion in his reasons for judgment:[148]

> Where governments in good faith, as in this case, invoke authority to realize desirable economic policies, they must know that they have no open-ended means of achieving their goals when there are constitutional limitations on the legislative power under which they purport to act. They are entitled to expect that the Courts, and especially this Court, will approach the task of appraisal of the constitutionality of social and economic programmes with sympathy and regard for the serious consequences of holding them *ultra vires*. Yet, if the appraisal results in a clash with the Constitution, it is the latter which must govern.

The political order criterion was perhaps violated by a recent British Columbia case[149] in which a taxpayer sought a refund of provincial

gasoline tax paid since 1937, claiming that the tax was beyond provincial legislative competence. To recover the taxes paid before August 1, 1974, the taxpayer could sue the provincial Crown only after submitting a petition of right to the cabinet and obtaining its approval in the form of a fiat permitting the action. For causes of action against the provincial Crown arising after August 1, 1974, the procedural requirement of a fiat has been abolished, so that the taxpayer could sue directly to recover the tax paid since that date. The provincial cabinet refused the fiat, on the advice of the Attorney General, possibly taking unfair advantage of the obsolete procedural hurdle to deprive the taxpayer of a "day in court" to challenge the taxing statute for the period ending in August 1974. The taxpayer sought judicial review of the cabinet's refusal, but a majority of the British Columbia Court of Appeal dismissed the application. Since we do not know whether the taxpayer had a strong case on the merits, we can conclude only that the taxpayer may have been denied justice. If the taxpayer had a weak case, the political order criterion might have been violated only in a technical sense.

Finally, a court interprets an ambiguous tax statute so as to minimize intrusion on individual rights and freedoms, applying the political order criterion as a guide to statutory interpretation.[150]

Both federal and provincial taxation statutes confer investigative powers on government officials that violate the political order criterion. The purpose of these powers is primarily to enable the officials to investigate and prosecute the offence of tax evasion but, particularly in recent years, the powers have also been directed toward scrutinizing lawful tax avoidance. Both purposes are legitimate, but the means of investigation must not offend political order.

Even before the *Canadian Charter of Rights and Freedoms*, at least one Canadian law reform commission had examined such revenue "snooper powers"[151] as:

1. The power to enter and search premises without a warrant;
2. The power to seize without a warrant; and
3. The power to enter, search and seize with a warrant.[152]

The Charter provides that "everyone has the right to be secure against unreasonable search or seizure."[153] Recently, for a majority of the Federal Court of Appeal, Pratte, J. summarized the Charter's possible impact on investigative power:[154]

> Searches and seizures are intrusions into the private domain of the individual. They cannot be tolerated unless circumstances justify them. A search or seizure is unreasonable if it is unjustified in the circumstances. Section 8 does not merely prohibit unreasonable searches and seizures. It goes further and guarantees the right to be secure against unreasonable search and seizure. That is to say that section 8 of the Charter will be offended not only by an unreasonable search or seizure or by a statute authorizing expressly a

> search or seizure without justification, but also by a statute conferring on an authority so wide a power of search and seizure that it leaves the individual without any protection against unreasonable searches and seizures. It is for that reason, in my view, that a statute authorizing searches without warrants may, as was decided in *R. v. Rao*, contravene section 8. A search without a warrant may or may not be justified irrespective of the fact that it was made without warrant; however, save in exceptional cases, a statute authorizing searches without warrants may be considered as offending section 8 because it deprives the individual of the protection that normally results from the warrant requirement.

Thus, the federal and provincial governments should review the investigative provisions in their revenue statutes to ensure that they contain adequate safeguards for the citizen.[155] Provisions authorizing warrantless searches or seizures should be repealed. Perhaps provisions authorizing the issuance of warrants should be amended, taking the power of issuance away from government officials and conferring it exclusively upon the judiciary. At the very least, provisions authorizing government officials to issue warrants should set forth the conditions of issuance and execution. Provisions should be enacted whereby claims of solicitor-client privilege may be submitted to and resolved by a judge. The retention and return of seized documents should also be prescribed.

Harmonization

Tax harmonization is perhaps becoming an important issue for several reasons. First, the European Economic Community has given it high priority.[156] Second, astute observers of the Canadian economy saw disturbing signs that the country was heading toward balkanization, that is, a more fragmented economy.[157] Third, royal commissions[158] and study papers[159] have discussed the problems of tax disharmony in the Canadian economy. Fourth, separation or sovereignty association with Quebec and alienation in Western Canada have raised broad questions about economic unity.[160] Finally, the process of constitutional reform has also raised issues concerning the reallocation of legislative powers between the federal and provincial levels of government.[161]

However, tax harmonization will not be treated as a fundamental tax policy criterion in this paper for the following reasons. First, unlike the criteria, harmonization does not have an established and precise meaning. Second, descriptions of the merits of harmonization are replete with reference to the basic criteria, prompting us to question whether harmonization adds a significant concept or is merely an application of more fundamental concepts. Two descriptions of harmonization appear to bear out these points:

> Tax harmonization refers to the degree to which federal and provincial governments exercise their respective powers of taxation in a co-ordinated manner to promote consistency and equity in the tax system. In this way,

> harmonization, in addition to preventing double taxation, helps to minimize economic distortions arising out of tax measures, simplifies procedures for taxpayers, encourages them to comply with tax laws and reduces collection costs for governments.[162]
>
> Within broad constitutional constraints, different levels of government in a federal system compete for revenue sources on the tax side of public sector budgets and for public approval on the expenditure side. Subfederal units of government ordinarily seek the highest possible degree of expenditure and taxation discretion. In pursuit of this fiscal freedom, however, some subfederal tax and expenditure policies may be considered or adopted which are inimical to national welfare. The task of fiscal harmonization is to secure fiscal arrangements between different levels of government that will enhance economic efficiency in the country.[163]

Third, Canadian economists appear to be in the process of reappraising the importance of the harmonization, feeling that the economic merits of decentralization, diversity and provincial independence have been overlooked.[164] Fourth, adopting a legal perspective, a constitutional lawyer might observe that fiscal sovereignty is a vital component of provincial sovereignty, and a legislature is unlikely to surrender its fundamental prerogative of voting on tax matters to Parliament. Finally, Canada is such a diverse country that uniform provincial taxes may not make economic or political sense. For these reasons we may conclude that if the various levels of government in Canada carefully and diligently pursue the tax policy criteria that we have previously discussed, they will at the same time achieve the proper amount of harmonization.

Ranking the Criteria

To make a judgment about a specific issue of taxation policy, we must rank the criteria in order of importance, apply them and decide whether on balance the criteria are satisfied. The criteria often conflict, meaning that any particular proposal will satisfy some criteria and violate others. To resolve these conflicts, we must balance the relative importance of the criteria, making compromises or trade-offs among them. Each of us will have personal preferences about the proper ranking of the criteria. Even a royal commission cannot agree upon the most important criterion. The Bélanger Commission felt that adequacy was the "primary purpose of taxes."[165] The highly influential Carter Commission gave "primacy of place" to equity (sacrifice standard).[166] The Smith Committee also felt that equity "rises above all the rest, both because a majority of the remaining characteristics flow from it and because it goes to the core of constitutional democracy."[167] The Meade Committee declined to address the question considering it to be a matter for "the political process" to determine.[168] The Asprey Committee felt that the three "dominant tests" were equity (sacrifice standard), practicality and neutrality.[169] Among contemporary policy analysts, neutrality is growing

and equity is declining in importance.[170] Our choice depends upon what we consider to be the most serious economic, social and political problems. For the purposes of this paper, our primary concern is the Canadian economic union.

An Appraisal of the Canadian Taxation System

Having outlined the division of taxing powers and the principal tax policy criteria, we are now in a position to make judgments regarding the merits of existing taxes. Since this paper is concerned with Canadian economic union, we should attempt to identify tax barriers to the free movement of people, goods and capital over provincial borders. We will also consider tax obstacles to free movement within a province. While our principal objections to these distortions are lack of neutrality and equity, we will consider other criteria as well. Our emphasis will be upon tax reform rather than exposition.

Income Taxes

The federal Parliament and provincial legislatures have the power to levy or authorize income tax on taxpayers or sources of income within their respective borders.[171] In the Canadian federal state, the federal government and each province could impose its own separate income tax computed according to different rules. Their respective delegates, the territories and municipalities, could also impose distinct income taxes. However much we may bemoan the complexity of Canadian income tax, most of us are fortunate enough to be required to complete only one annual form, even if we have sources of income in several provinces. Canada has developed a highly integrated comprehensive income tax system, implemented through the federal *Income Tax Act* and provincial income tax acts and the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*.[172] The Ontario Economic Council aptly praised the Canadian income tax system for its exemplary harmonization:[173]

> Canada has one of the most decentralized federations in the world. Moreover, in terms of the proportion of income tax revenues, both personal and corporate, that accrues to the provincial governments, Canada has one of the more decentralized income tax systems in the world. Yet we have succeeded in maintaining a degree of coordination and harmonization in the income tax field that is the envy of other federations. This degree of integration and harmony is a remarkable achievement in light of the fact that scarcely forty years ago the Rowell-Sirois Commission called the highly uncoordinated, allocatively inefficient and openly beggar-thy-neighbour approach to income taxation that prevailed during the depression a veritable "tax jungle".

Despite the accuracy of this praise, we can fault both the personal and corporate income taxes for interfering with the free movement of persons and capital throughout the Canadian economic union.

Personal Income Taxes

By personal income taxes, we mean taxes on the non-business income of individuals. Every individual resident in Canada (or a non-resident having a Canadian income source) is liable to pay federal income tax on taxable income.[174] An individual is also liable to pay territorial or provincial tax on non-business income, imposed by the jurisdiction within Canada where the taxpayer resides at the end of the taxation year.[175] The federal, provincial, and territorial taxes on the business income of individuals will be discussed under the heading "Corporate Income Taxes," since the corporation is the most common form of business enterprise. For all provinces except Quebec, provincial individual income tax is a flat percentage of the taxpayer's basic federal tax (federal income tax minus certain tax credits).[176] Quebec imposes, administers and collects its own personal income tax and individuals residing in that province at the end of the year must file separate federal and provincial income tax returns.[177] Residents of the other provinces and the territories file only one annual return, because under tax collection agreements with the other provinces, the federal government administers, collects and remits their income taxes to the provincial and territorial governments.[178]

We shall now describe some personal tax factors bearing upon the free movement of persons and capital.

Free Movement of Persons

Under this heading, we shall consider migration to and from Quebec and tax-free fringe benefits.

Migration to and from Quebec Despite Quebec's separate personal income tax, the tax position of someone moving into or out of Quebec during the year is not complicated by the employer's withholding federal and provincial income taxes on salary or wages or by other instalment payments of provincial income tax. Specifically, an employee moving from Alberta to Quebec should have had Alberta income tax deducted from each pay cheque up to the date of the move. Assuming the taxpayer at the year-end is a resident in Quebec, it will give the taxpayer a tax credit for the Alberta tax withheld and Alberta will reimburse Quebec for the tax credit. If a Quebec resident moves to Alberta, tax credit and reimbursement are reversed. These reciprocal provisions coordinate Quebec's separate personal income tax with the tax systems of the other

provinces.[179] The other agreeing provinces have similar reciprocating provisions to provide relief for taxpayers who move during the year.[180]

Tax-free fringe benefits To both employer and employee, a tax-free fringe benefit offers income tax advantages. The employer may deduct it as a business or salary expense in computing the taxable profit of the business. Since the employee receives the benefit free of tax, it may be worth more than its actual cost to the employer. If the employee had to purchase the equivalent of the benefit out of after-tax salary or wages, it would cost more. For example, to an employee in the 50 percent income tax bracket, a $100 tax-free fringe benefit is worth twice as much, since the employee would have to earn $200 before tax to be able to purchase it. Two tax-free fringe benefits influence worker mobility because of geographical factors: board and lodging at a special or remote work site, and the northern or isolated post benefit and allowance.

Special or remote work site Ordinarily, if an employer supplies or pays for an employee's personal board or lodging or transportation to and from work, the employee receives a taxable fringe benefit. Subsection 6(6) of the *Income Tax Act*[181] exempts such benefits in connection with work at (1) a temporary, distant location, called a special work site, or (2) a remote location. For readers who wish to grapple with a typical income tax provision, subsection 6(6) is set out in full:

> 6(6) . . . in computing the income of a taxpayer for a taxation year from an office or employment, there shall not be included any amount received or enjoyed by him in respect of, in the course of, or by virtue of his office and employment that is the value of, or an allowance (not in excess of a reasonable amount) in respect of expenses incurred by him for,
> (a) his board and lodging at
> (i) a special work site, being a location at which the duties performed by him were of a temporary nature and from which, by reason of distance from the place where he maintained a self-contained domestic establishment (in this subsection referred to as his "ordinary place of residence") in which he resided, he could not reasonably be expected to return daily to his ordinary place of residence, or
> (ii) a location at which, by virtue of its remoteness from any established community, the taxpayer could not reasonably be expected to establish and maintain a self-contained domestic establishment,
> in respect of a period while he was required by his duties to be away from his ordinary place of residence, or to be at the location, for a period of not less than 36 hours; or
> (b) transportation between
> (i) his ordinary place of residence and the special work site referred to in subparagraph (a)(i), or
> (ii) the location referred to in subparagraph (a)(ii) and a location in Canada or a location in the country in which the taxpayer is employed,

in respect of a period described in paragraph (a) during which he received board and lodging, or a reasonable allowance in respect of board and lodging from his employer.

Subsection 248(1) of the act defines "self-contained domestic establishment" as meaning:

"self-contained domestic establishment" means a dwelling house, apartment or other similar place of residence in which place a person as a general rule sleeps and eats;

This exemption benefits employees particularly in the construction, fishing and marine industries. Their employers perhaps appropriate some of the exemption through paying lower wages than might otherwise be required. In short, the exemption may reduce labour costs in those industries.

The rationale for the exemption appears to be that where a person chooses to live is usually a personal matter, so that board and lodging and commuting expenses are not deductible and must be paid from earnings after tax, but where an employer sends an employee to a special work site, the employee cannot be expected to move his place of residence nearer because it is merely a temporary place of employment. Similarly, if the employee goes to work at a remote location, because of its remoteness, he cannot move near it. In both cases, job requirements rather than personal choices determine where the employee must live, and the employee receives no personal benefit from the employer's expenditures for board, lodging and transportation.[182] If this is the rationale, subparagraph 6(6)(a)(i) seems to defeat it by requiring the employee to *maintain* a self-contained domestic establishment. Since to maintain means to support or keep up, the taxpayer must incur duplicate living expenses for his regular home while at the special work site. The requirement to maintain a domestic establishment violates neutrality and equity. Comparing two employees living at a special work site, one of whom maintains an apartment in town, the other living rent-free with his parents in the same town, subparagraph 6(6)(a)(i) would deny the exemption to the latter taxpayer. Because of the serious unemployment problems of our young people, many live at their parents' homes to economize, and the requirement of maintaining a place of residence hits them the hardest. For these reasons, Parliament should repeal the requirement to maintain a self-contained domestic establishment in subparagraph 6(6)(a)(i).[183]

Northern or isolated posts benefit and allowance Under section 17 of the *Financial Administration Act*,[184] the Treasury Board, in 1980, promulgated a regulation entitled the *Isolated Posts Benefits and Allowances Remission Order*.[185] The order was reissued for 1981 and extended for 1982 in the November 1981 federal budget. A press release dated December 2, 1982, extended it for the 1983 taxation year.[186] Then, in a

release on December 9, 1983, the earlier release was countermanded and the remission order would be extended indefinitely.[187] Finally, in November 1984, the government announced that the order will remain in effect until December 31, 1985.[188] Taxation (or exemption) by press release hardly satisfies the requirements of practicality (certainty) or political order.

To qualify for the exemption, an employee must live either north of the 60th parallel of latitude, in Labrador or in an isolated post as defined by the Treasury Board in the remission order, according to population, remoteness and inaccessibility. Employees who live in these areas and whose benefit plans began on or before November 12, 1981, are entitled to tax exemption for low cost housing benefits, cash allowances for housing, and financial assistance to travel for vacation or medical purposes. However, employees whose benefit plans began after that date will be taxable on the full amount of cash allowances for housing, subject to the possibility of transitional relief.[189] Low cost housing benefits and financial assistance for travel will be partially exempted from income tax. The taxable benefit for subsidized vacation travel by employees and their families will be limited to $250 for each of two trips a year to the nearest metropolitan centre. Other travel benefits will be fully taxable. The upper limit of the taxable portion of low-cost housing benefits is the lesser of: (1) 20 percent of income from employment and (2) complex dollar limits for different types of accommodation, varying with location and indexed for inflation. Since the proposed scheme eliminates or reduces the income tax burden on in-kind housing benefits and cash payments for certain purposes, it fails both the equity and neutrality criteria. Employees in the same locations who do not receive such benefits bear heavier taxes. The exemption compensates for the high costs of living and travelling in northern and isolated areas and to stabilize the northern economy. However, the proposed exemptions are too narrow and arbitrary.[190] The Department of Finance should reconsider the exemptions and introduce them in proper legislative form.[191]

Free Movement of Capital

As we have seen, the Canadian Constitution generally permits provincial taxes interfering with the free mobility of capital. Under the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*,[192] the provinces, other than Quebec, have entered into tax collection agreements whereby the federal government collects and administers provincial personal income taxes. Compared with the Constitution, these place much more onerous restraints on provincial tax policies. A province which exceeded one of these limits would violate the tax agreement, not the Constitution; these limits are contractual (between the levels of government), rather than constitutional.[193] Within these contractual limits, the province can set the rate of

provincial tax applied to the taxpayer's basic federal tax. Provincial income tax policy in an agreeing province is limited to establishing (1) its tax rate and (2) its own scheme of tax credits deductible from provincial income tax. The federal Finance Department will accept such credits only if they meet three general guidelines:[194]

> First, the measure must be able to be administered reasonably effectively. Second, the measure must not significantly erode or have the potential to erode the essential harmony and uniformity of the federal and provincial income tax systems. Third, the measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of income tax barriers to normal interprovincial investment flows.

In applying these guidelines the Finance Department must strike a balance between allowing the provinces enough flexibility in formulating tax policies to keep them within the joint collection system without permitting provincial measures threatening to the system's harmony and uniformity.[195]

We shall now examine provincial personal income tax provisions intended to attract investment capital to and keep it in the province.

Quebec stock savings plan In 1979,[196] the Quebec assembly enacted personal income tax legislation permitting an individual, other than a trust, resident in Quebec on the last day of a taxation year, to establish for provincial income tax purposes a stock savings plan and to deduct annually the cost of new shares in Quebec companies purchased on behalf of the plan, up to the lesser of $20,000 or 20 percent of total income. The object of the legislation is to create a provincial tax stimulus to public investment in new equity issues of Quebec-based companies.[197]

British Columbia dividend and housing and employment bond tax credits In 1979,[198] British Columbia enacted a 5 percent dividend tax credit to be deductible from provincial income tax for dividends received from a public corporation having its head office and central management in British Columbia. The federal government refused to administer the credit. Since the credit would obviously encourage companies to locate their head office and central management, in effect, their residence, in British Columbia, it would appear to violate the third guideline. British Columbia has not proclaimed it and it has not taken effect.

In 1982, British Columbia enacted the housing and employment development tax credit.[199] The federal government agreed to administer it on behalf of the province but refused to recognize it for federal income tax purposes. In 1983, the province proclaimed the credit in effect against provincial income tax only. The tax credit is part of a scheme[200] whereby the provincial government will raise money by issuing bonds and lend the proceeds to eligible borrowers to create employment within the

province.[201] The credit will exempt interest income earned by the bonds from provincial tax.[202] Where the credit exceeds provincial income tax otherwise payable, the difference will be refunded to the taxpayer.[203] Where the bondholder is not required to pay provincial income tax, the full amount of the credit will be refunded.[204] The Ontario Economic Council described the federal decision to accept this credit as[205]

> . . . a very important precedent. . . . This is a remarkable concession by the federal government, since the end result will be to erect barriers to interprovincial flow of enterprises and capital.

Corporate Income Taxes

A Canadian resident corporation is liable to pay federal and provincial or territorial corporate income taxes. All the provinces except Alberta, Ontario and Quebec have entered into tax collection agreements with the federal government adopting a common tax base and centralizing collection and administration.[206] Alberta, Ontario and Quebec impose, administer and collect their own corporate income taxes.[207]

We shall briefly describe some corporate tax incentives created by the federal and the provincial governments violating *equity* and *neutrality* and interfering with the free movement of capital and business entrepreneurship.

Federal Investment Tax Credit

As a stimulus to new business investment in buildings, machinery and equipment and in scientific research and development, an investment tax credit is deductible against federal tax payable.[208] Individuals, trusts and corporations carrying on business can claim the credit. Unused credits may be carried forward for up to seven years and back for three years.[209] The investment tax credit is calculated as a percentage of the cost of qualifying expenditures, the rate depending on the type of expenditure and the region. (See Table 4-1.)

Quebec SODEQ Tax Credit

In 1976, Quebec established a tax credit to encourage the incorporation of companies offering venture capital to eligible Quebec-based manufacturing firms.[210] The venture capital companies are called sociétés de développement de l'entreprise québécoise (SODEQ). As a tax incentive to stimulate investment, a purchaser of shares issued by a SODEQ may deduct a tax credit from Quebec personal or corporate income tax equal to 25 percent of the equity investment to a maximum of $25 a share, and may carry forward unused tax credit to future years.[211]

TABLE 4-1 Federal Investment Tax Credit

Region Expenditure Invested in	Tax Credit as a Percentage of Qualified Property Expenditure	Qualified Scientific Research Expenditure	Qualified Transportation and Construction Equipment Expenditures
1. Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, and the Gaspé Peninsula	20	20[a]	7
2. Prescribed designated regions under the *Regional Development Incentives Act* excluding those in 1 above[c]	15	10[a]	N/A
3. Certified property, prescribed areas under the *Regional Development Incentives Act*[d]	50[b]	N/A	N/A
4. Rest of Canada	7	10[a]	7

Source: Derived from Price Waterhouse, *Doing Business in Canada* (1983), p. 140.

a. 35 percent if incurred anywhere in Canada by a Canadian-controlled private corporation that would be eligible for the small business deduction if it had taxable income.
b. Acquired before 1986.
c. Prescribed designated regions comprise Northern Quebec, Ontario, Alberta and British Columbia, all of Manitoba, Saskatchewan, the Northwest Territories and the Yukon.
d. Prescribed areas include most of Newfoundland, all of the Yukon and Northwest Territories, most of the Gaspé region and northern parts of the remaining provinces.

Ontario SBDC Tax Credits

In 1979, Ontario established a tax credit to encourage similar investment in venture capital entities called small business development corporations (SBDC).[212] A corporation may claim a tax credit against Ontario corporate income tax in the amount of 30 percent of the amount invested in new equity issued by an SBDC.[213]

Saskatchewan Venture Capital Program

In June 1984, Saskatchewan implemented a program similar to those in Quebec and Ontario,[214] effective for 1984 and subsequent years. Unlike Quebec and Ontario, however, Saskatchewan had previously entered into

tax collection agreements with the federal government covering the collection of both personal and corporate income taxes. The federal Finance Department has agreed to administer the venture capital tax credit for the province. In so doing, the department appears to have interpreted its guidelines (see text *supra*, at note 194) more permissively than it did in 1979 when it rejected British Columbia's proposed dividend tax credit (see text *supra*, at note 198); but because the Saskatchewan program focusses on small local business, it may be less open to the objection that it constitutes a barrier "to normal interprovincial investment flows" (see text *supra*, at note 194) than the British Columbia proposal which was aimed at attracting public companies to the province.

Under the venture capital program Saskatchewan will give a tax credit to individual and corporate taxpayers investing in the equity of venture capital corporations (VCC) which must, in turn, invest in prescribed types of small businesses in the province. The tax credit equals 30 percent of the amount invested and may be carried forward for up to seven years. Tax-exempt investors may claim a grant of the same 30 percent. A VCC must generally have a minimum equity capital of at least $100,000 and not more than $5 million, but if it is based in a community with a population of less than 5,000 and invests in businesses in that community, a VCC may have a minimum equity capital of $25,000.

Other agreeing provinces may follow Saskatchewan's lead and fashion similar tax incentives to attract investment capital. From a tax policy perspective, we may well question the wisdom of such incentives, but the provinces have the prerogative of withdrawing from the tax collection agreements and the federal Finance Department must make compromises to keep the provinces within the agreements.

Allocation Rules

Where a corporation (or individual) carries on a business across provincial or territorial borders, the business income must be allocated to particular provinces or territories for tax purposes. These allocation rules are intended to apportion the income to the jurisdiction producing it, satisfying the equity (benefit) criterion and to prevent interjurisdictional tax avoidance and double taxation. Tax avoidance would occur if income were not allocated to a province or territory; double taxation, if the same income were allocated to two or more provinces or territories. Uniform allocation rules uniformly applied by all the provinces prevent interprovincial tax avoidance and double taxation.[215] The allocation rules have three elements: (1) the requirement of a permanent establishment in the province or territory; (2) the definition of permanent establishment; and (3) a formula for apportioning income among the provinces or territories.

To become liable for provincial or territorial income tax, an individual

taxpayer who is not a resident of the jurisdiction must earn business income and the business must have a permanent establishment in the province or territory.[216] Similarly, a corporation is liable for provincial or territorial income tax only if it has a permanent establishment in the jurisdiction.[217] Among the agreeing provinces, the definitions of permanent establishment are identical.[218] Among the non-agreeing provinces, Alberta[219] follows those definitions, but Ontario[220] and Quebec[221] do not do so entirely, thereby raising the prospect that either of them and another province or territory may impose tax on the same business income.

Furthermore, Alberta has objected to the mathematical formula[222] whereby income is apportioned to each province or territory under the federal income tax.[223] Because the formula is based on sales and payroll in the province, Alberta objects that it allocates business income from natural resources to consuming provinces having sales and population such as Ontario and Quebec, rather than to producing provinces lacking those factors.[224] To avoid double taxation, Alberta has put aside its objections and reluctantly applies the common formula.[225] Ontario[226] and Quebec[227] do so as well. But Ontario's and Quebec's departures from the common definition of permanent establishment create a potential for double taxation. To prevent further interference with interprovincial free trade, the non-agreeing provinces must adhere to the same allocation rules.

Investigatory or Feasibility Expenses

The old saw that you should investigate before you invest is poor tax advice! The costs of investigating the feasibility of a prospective business venture are not deductible as business expenses if the taxpayer incurs them and never establishes the business. Once the business is established for tax purposes, further investigatory costs are deductible as current expenses.

In the *M.P. Drilling Ltd.* case,[228] the taxpayer was incorporated in 1963 as a vehicle to market liquid petroleum gases overseas. From 1964 to 1966, the company incurred expenses, making feasibility studies and negotiating with prospective suppliers and customers. The marketing business never advanced beyond this stage and, in 1966, the company changed its name and forsook marketing for drilling. The minister disallowed the company's claim to deduct these marketing expenses on two grounds: (1) the expenses were capital outlays; and (2) the expenses did not produce revenue. The taxpayer appealed to the Federal Court and succeeded at trial and on an appeal by the minister. Rejecting the minister's first argument, the Court of Appeal held that feasibility or investigatory expenses incurred before business begins are capital outlays and that those incurred after the commencement of the business are

currently deductible. Urie, J. said that the taxpayer "was *in fact in business* and was not simply bringing the business into existence."[229] The court rejected the minister's second argument, holding that expenses were deductible even if they produced no revenue and created a loss, as long as the taxpayer incurred the expenses for the purpose of earning income.

In a more recent case, Mr. Squires,[230] the taxpayer, joined with two other individuals to investigate the feasibility of establishing a profit-making tennis and squash club. When the local municipality refused the necessary permits, the taxpayer and his associates gave up the idea. Squires claimed to deduct as business expenses his share of the costs of a marketing study and consulting fees, business meals, maintenance household expenses, travel to Florida and automobile expenses. Obviously some of these expenses looked suspiciously like personal outlays. The minister disallowed all of the expenses. On appeal, the Tax Review Board upheld the minister's disallowance, following the principle of the *M.P. Drilling* case, that feasibility expenses incurred in investigating a business venture that never begins are not deductible. In this case, the board held that the racquet club business never came into existence.

In summary, the *Income Tax Act* treats feasibility and investigatory expenses in three ways. First, if the taxpayer incurs the expenses after the business begins, they are currently deductible. Second, if the taxpayer incurs the expenses before the business begins, they are capital outlays. Before 1972, such capital outlays were not deductible and were called "nothings." Since 1972, the act permits their amortization against business income as eligible capital expenditure.[231] However, to qualify for amortization, the business must come into existence.[232] Third, if the business never starts, the expenses are non-deductible nothings.[233] The disallowance of such expenses violates equity, neutrality and economic stability because it favours established businesses and creates a barrier to new ventures. The *Income Tax Act* should be amended to permit the deduction of genuine investigatory and feasibility expenses incurred where the prospective business never comes into existence. Because the taxpayer incurred these expenses for a capital (long-term) purpose, they are capital outlays. Like other capital outlays, only half of the amount should be deductible. However, because the expenses did not produce a long-term advantage, they should be currently deductible in the year rather than amortized over a period of years. Finally, like allowable business investment losses, these expenses should be deductible from all sources of income.

Provincial Retail Sales Taxes

All the provinces except Alberta impose a retail sales tax.[234] The Yukon and Northwest Territories do not impose sales tax. For years the courts

struck down provincial sales taxes as indirect and beyond provincial competence. The current provincial sales taxes qualify for constitutional purposes as direct taxes because they are imposed on the ultimate consumer or user of tangible personal property or services, and the vendor is merely the collection agent on behalf of the provincial government.[235]

On a good or service entering over a provincial border, retail sales tax is imposed according to the destination principle.[236] The province where the good or service is used or consumed imposes sales tax on the taxpayer residing or carrying on business there,[237] and the province of production either exempts[238] the good or service from sales tax or refunds[239] to the purchaser the tax paid at the time of purchase. For exemption, the seller must either deliver or ship the good by common carrier outside the province. To obtain a refund, the purchaser may be required to prove payment of sales tax to another province where the good is used or consumed and must apply within three years.

Neutrality

The destination principle satisfies the neutrality criterion since goods or services bear the same rate of tax — that imposed by the province of consumption, whether they were produced in that province or in another province having a different tax rate. However, the destination principle does not meet the adequacy and practicality criteria. On the importation of a taxable good or service into a province, the importer should file the proper forms, pay the provincial sales tax owing and claim a refund from the provincial government where the good or service originated. Unlike federal customs duty and sales tax, which are collected by customs officials at the national borders, post offices and so on, the provincial sales taxes on imports from other provinces are not collected at provincial borders. The taxpayer is required to report the importation and pay the tax, with sanctions for violators. Except on imported motor vehicles whose ownership must be registered with the provincial government, consumers seldom pay sales tax on imports. Similarly, the procedure for obtaining a refund from the province of production is inconvenient, and few taxpayers know about it. To avoid provincial sales tax, a purchaser in a taxing province may prefer interprovincial mail-order or cross-border shipping, instead of buying from a local merchant.[240] Thus, the provincial sales tax may distort interprovincial competition, violating neutrality.

Provincial taxes on imports of gasoline,[241] alcohol[242] or tobacco[243] for consumption are further instances of the constitutional validity of the destination principle and have been upheld as direct taxes.[244] Alcohol sales taxes have been upheld as valid provincial legislation incidental to the creation of a liquor board monopoly.[245] Alcohol and tobacco sales taxes are also justifiable for the purpose of regulating the consumption of products injurious to the health of consumers in the province.

We shall consider some ways in which provincial retail sales tax impedes the free movement of goods within the Canadian economic union.

Double Taxation of Imports

From 1975 to 1982, Nova Scotia, through its retail sales tax, tried to discriminate against purchases outside the province and failed. Provincial sales taxes are generally imposed on the sale price or fair value of goods or services; where a vendor takes a trade-in toward the price, the tax is imposed on the net price after deducting the value of the trade-in. In 1975, Nova Scotia amended its sales tax, allowing trade-in credit only on purchases in the province.[246] A purchaser making a trade-in purchase outside the province and importing the item was required to pay sales tax on the full price. According to the provincial *Hansard*, the Nova Scotia government intended to encourage consumer sales in the province.[247]

In *Re Clearwater Well Drilling Limited*,[248] the Nova Scotia Court of Appeal thwarted the amendment. The taxpayer had purchased equipment outside the province, partially paying for it with a trade-in and, on bringing the equipment into Nova Scotia, the province denied credit for the value of the trade-in. At trial, the taxpayer unsuccessfully challenged the amendment as an invalid indirect tax.

On appeal, Jones, J.A. dissented, holding that the amendment was unconstitutional because the legislature had deliberately erected "a barrier to the free flow of goods into the Province."[249] Without deciding the constitutional issue, the majority interpreted the amendment so as to render it meaningless and ineffective and the province repealed it, to replace it with a more effective provision. Jones, J.A.'s reasoning is contrary to many cases holding that a sales tax which discriminates against imports by imposing double taxation is nevertheless valid.[250] Since 1887, the courts have interpreted the *Constitution Act, 1867*, as permitting interprovincial double taxation.[251]

When subsection 15(1) of the *Canadian Charter of Rights and Freedoms* comes into effect, it will prohibit discrimination, but the courts are unlikely to overturn the well-established constitutional rule permitting double taxation. New Brunswick[252] and Prince Edward Island[253] have retained similar provisions to the one that the Nova Scotia Court of Appeal frustrated; and Nova Scotia, unrepentant, has enacted another provision.[254] These provisions should be repealed.

Interprovincial Carriers

Provincial retail sales taxes have been assessed upon interprovincial carriers such as airlines, railways, and hauliers, raising difficult issues of constitutional law and taxation policy. Provinces have attempted to

assess interprovincial airlines on in-flight sales of alcoholic beverages, but the courts, holding that in-flight sales do not take place within the province, under subsection 92(2) of the *Constitution Act, 1867*, have overturned the assessments.[255] The constitutional principle applies to sales on all flights: over-flights, temporary stopovers, and flights originating or terminating (or both) in the province.[256]

The provinces have also attempted to assess interprovincial airlines for sales tax on the cost of the aircraft, component parts, equipment and other tangible personal property purchased outside the province and brought in for the airline's use. The courts have held that a province cannot impose tax on the cost of aircraft, etc., engaged in overflights or temporary stopovers since they are not within the province under subsection 92(2).[257] On the other hand, aircraft on flights originating or terminating or serving more than one point in the province are within it for the purposes of this aspect of the sales tax while, at the same time, the in-flight sales of drinks take place outside the province.[258] Whether an aircraft is within the province is a complex factual question depending on the use of each individual airplane on each flight. The test adopted by the Supreme Court of Canada is extremely vague. Macfarlane, J.A., of the British Columbia Court of Appeal, described it as follows:[259]

> On that question a substantial or at least sufficient presence must be shown. Transportation involves a spectrum of activity. At one end of the spectrum of aircraft activity are overflights, which never have a real presence within the province. At the other end are aircraft based in British Columbia, which take off and land only in British Columbia. I would have no difficulty in concluding (in the absence of precedent) that the former do not have a substantial presence within the province, but that the latter do. Temporary stopovers . . . involve aircraft having a transitory or momentary presence within the province. The distinction between those aircraft which have only a nominal presence and those which have a sufficient presence to form a basis for taxation, is in some circumstances, difficult to draw.

The British Columbia Court of Appeal also applied the substantial, or at least sufficient, presence test to determine whether an American trucking company carrying on business in the province was liable for sales tax on its trucks.[260] The court held that the company was not liable for sales tax on trucks carrying bonded goods from Washington state to Alaska, because the vehicles were insufficiently present within the province.

While these decisions may seem illogical, they strengthen the Canadian economic union. First, by striking down provincial attempts to tax purchases of drinks in flight, the courts have tried to protect the free mobility of air passengers and to discourage taxes that could ultimately disrupt interprovincial travel. Second, in denying provincial sales tax on airplanes or trucks that are merely passing over or through a province, the courts have prevented provincial corridor taxes, thereby enhancing the free mobility of goods. Third, by holding that a province can impose

sales tax on airplanes or trucks that are substantially within the province, the courts are attempting to ensure equity and neutrality in the taxation of intraprovincial and interprovincial carriers so that they can compete on equal terms.

To avoid double taxation, the provinces impose sales tax only on that portion of the cost of eligible aircraft, repair parts, etc., reflecting mileage of the aircraft within the province as a percentage of total mileage. The British Columbia Court of Appeal felt that this prorating satisfied equity (benefit standard). The same allocation formula applies to provincial sales tax imposed on interprovincial hauliers for the cost of trucks and component parts purchased outside and used within the province for interprovincial haulage. In British Columbia, these allocation rules are set out in administrative guidelines rather than in legislative form.[261] Such publications neither carry the force of law nor bind the government publishing them.[262] Their existence is not widely known. Hutcheon, J.A., of the British Columbia Court of Appeal, said of these administrative allocation rules:[263]

> It is remarkable to find this charging provision in the instructions rather than in the statute.

To satisfy practicality and political order, the allocation rules should be enacted in statutory or regulatory form.

Construction Contractors

In *Re Rush and Tompkins Construction Ltd.*,[264] the taxpayer, an Alberta construction company, had been awarded a federal government road building contract to be performed in Glacier National Park, British Columbia. British Columbia assessed the taxpayer for sales tax on its tangible personal property, such as equipment and parts brought into the province temporarily to perform the contract. The British Columbia Supreme Court upheld the assessment. The effect of such a tax is to interfere with the free mobility of enterprises by erecting a tax barrier to out-of-province contractors, increasing their costs. Since the contractor was based in Alberta which does not impose sales tax, British Columbia could make a protectionist argument that the imposition of sales tax merely equalized the competitive conditions with those of local contractors and deprived the Alberta contractors of their tax haven[265] competitive advantage. According to the equity and neutrality criteria, the argument cannot withstand scrutiny. Other provinces grant sales tax relief for goods brought into the province for a merely temporary purpose.

Settlers' Effects

Personal effects brought into certain provinces by a non-resident individual intending to take up residence are exempted from sales tax.[266]

The exemption removes a barrier to the free movement of persons seeking residence. However, since the exemption does not extend to migrant workers intending to work in the province without taking up residence, sales tax interferes with the free movement of workers across provincial borders, and appears to violate paragraph 6(2)(b) of the *Canadian Charter of Rights and Freedoms*. Ontario's exemption for settlers' effects permits proprietors or owners of businesses to move their businesses into Ontario free of sales tax on the business personalty.[267] Other provinces should adopt similar exemptions to encourage freedom of business establishment.

Gift and Succession Duty

After 1977, all the provinces had abolished gift and succession duty. Later, Manitoba, Ontario and Quebec reintroduced them. Now Quebec is the only province levying gift and succession duty.[268] Alberta and the Territories have never imposed the taxes. When they were in force, the taxes weakened the Canadian economic union by interfering with the free movement of capital. They caused interprovincial double taxation[269] and tax avoidance.[270]

The courts held that under the Constitution, a province may impose succession duties based on: (1) the situs (location) in the province of property owned by a deceased; (2) the transmission of personal property outside the province to a beneficiary resident or domiciled in it; and (3) a beneficiary resident in the province.[271] When the situs of property was in one province and the beneficiary in another, the rules created the prospect of double taxation. However, the courts[272] laid down three principles regarding the situs of intangible property for provincial succession duty purposes which prevented some double taxation: (1) intangible personal property has only one situs, (2) the situs must be determined according to common law, and (3) a provincial legislature cannot alter the common law situs of intangible property. Apart from the situs rules, the courts held that the Constitution permitted double taxation.[273] Taxpayers depended on unilateral or reciprocal exemptions or tax credits enacted by the provincial legislatures to relieve them from double taxation.

Interprovincial succession duty avoidance often involved the freezing of one's estate by transferring investments which would be exigible on death to a holding company incorporated in a tax haven such as Alberta or one of the Territories and issuing shares in the holding company to family members or to their tax haven companies. Succession duty freezes inspired the incorporation of many holding and subsidiary companies in tax havens and the transfer of wealth accumulated in other provinces, thereby distorting the free movement of capital.

Provincial succession duties could also distort capital flows by applying higher tax rates to non-resident beneficiaries receiving property

located in the province. The courts upheld the validity of heavier taxation of non-residents.[274]

On balance, the repeal of succession duties in all the provinces except Quebec has strengthened the Canadian economic union.

Provincial Natural Resource Taxes

In recent years, natural resource taxation has strained federal-provincial and interprovincial relations.[275]

Natural resource enterprises must pay federal and provincial taxes and royalties. Although some royalties are merely taxes by another name, strictly speaking a royalty is a return to the Crown as the owner of public land from which a natural resource has been produced. Since none of these taxes and royalties is deductible from any other, natural resource enterprises are subjected to double or multiple taxation.

The constitutional limits of provincial taxing powers over natural resources are set out in subsections 92(2) and 92A(4) of the *Constitution Act, 1867*, which we have already discussed. We noted that subsection 92A(4) authorizes the provinces to impose excise taxes on natural resources, forestry and electrical energy production exported from the province according to the origin principle.

Neutrality of an origin or source-based tax requires strict uniformity among the provinces. Tax differentials can distort interprovincial trade. If there is a disparity among the taxes or rates of producing provinces and it affects costs of production and prices, the cheaper output of the lower-tax province will outsell that of the other province. Professor Thirsk has said:[276]

> If origin taxes were adopted by non-federal governments, uniform rates would be required in all jurisdictions in order to avoid serious economic distortions.

To integrate the Canadian economic union and to attain neutrality, provincial taxes introduced pursuant to subsection 92A(4) of the *Constitution Act, 1867* should be uniform.

Provincial Corporate Capital Taxes

British Columbia, Saskatchewan, Manitoba, Ontario and Quebec impose taxes on the capital of a corporation having a permanent establishment in the province.[277] Newfoundland taxes the capital of bank, loan and trust companies only.[278] Quebec began imposing the tax in 1882, later withdrawing it. Since the Second World War, the tax has proliferated: Quebec, 1947; Ontario, 1957; British Columbia, 1973; Manitoba, 1976; Saskatchewan, 1980; and Newfoundland, 1982. After introducing the tax at "nuisance" rates, the provinces have steadily increased them.

Each province adds its own nuances to the definition of taxable capital, but it generally comprises paid-up capital, earned surplus or retained earnings and other surpluses, reserves and various loans and advances received, less allowances for investments and goodwill. The courts permit double taxation, holding that taxable capital may include that employed outside the province.[279] To prevent double taxation, the provinces impose tax only on the capital employed in the province apportioned according to the income tax allocation rules based on sales and payroll in the province, which we have previously mentioned.

The tax is popular with provincial governments but not with some policy analysts.[280] The tax catches a company that escapes income tax because it has no taxable income.[281] It diverts tax revenue to the provincial government that would otherwise have gone to Ottawa because the taxpayer may deduct the tax in computing taxable income.[282] If the federal government wished to prevent the erosion of its tax revenue, it could disallow the deduction of corporation capital tax. The Bélanger Commission (1965) and Smith Committee (1967) felt that the tax should be repealed because it violated adequacy, practicality, equity, and neutrality.[283] Since it diverts tax revenue from the federal government, we might add that the tax violates political order.

The Bélanger Commission felt that the tax was non-neutral because it distorted the conditions of interprovincial competition, prejudicing domestic producers by increasing production costs:[284]

> Capital tax saps the strength of Quebec enterprises competing against those in other provinces.

The economic union would be better off without the tax, but obviously the provinces want the revenue.

Provincial and Municipal Property Taxes

Municipalities impose property taxes on the owners of real property and business taxes on the occupants of business premises, within municipal boundaries. The provinces impose property taxes on the owners of other real property.

While an early Manitoba case[285] struck down a provincial property tax because the rate for non-resident owners was five times greater than that for residents, the better view is that the courts have little control over property taxes interfering with the efficient operation of the Canadian economic union.

In the leading case,[286] the Supreme Court of Canada upheld Prince Edward Island legislation enacted in 1972 prohibiting non-residents of the province from acquiring shore-frontage exceeding five chains or other lots above ten acres without the provincial cabinet's approval. For the court, Laskin, C.J.C. said:[287]

> No one is prevented by Prince Edward Island legislation from entering the province and from taking up residence there. Absentee ownership of land in a province is a matter of legitimate provincial concern. . . . In the present case, the residency requirement affecting both aliens and citizens alike and related to a competent provincial object, namely, the holding of land in the province and limitations on the size of the holdings (relating as it does to a limited resource), can in no way be regarded as a sterilization of the general capacity of an alien or citizen who is a non-resident, especially when there is no attempt to seal off provincial borders against entry.

The Supreme Court of Canada evidently felt that a province could not prohibit the free movement of persons across its borders but could regulate where they resided or worked. Surely free movement implies freedom of choice and opportunity. Perhaps subsection 6(2) of the *Canadian Charter of Rights and Freedoms, 1982* has overturned the Supreme Court's whole approach. However, the Supreme Court's view that a province can discriminate against absentee landowners remains unaffected by the charter and a province may erect barriers to the free movement of investment capital intending to cross its borders to purchase land. Since businesses require premises from which to conduct their activities, discriminatory land taxes can interfere with free movement of entrepreneurship.[288]

In 1974, Ontario enacted a land transfer tax discriminating against non-residents of Canada. The Ontario High Court upheld the validity of the tax despite its imposition of a heavier rate on non-residents of Canada.[289]

Since the provinces have wide sovereignty to impose property taxes which are protectionist and discriminatory against non-residents, they can damage the productivity of the Canadian economic union. Unfortunately, the courts have not appreciated that land is a component of the Canadian economic union. Perhaps the courts feel that because land is fixed and an economic union consists of the free mobility of people and goods, land is not part of it. However, free mobility obviously has a geographic aspect, to which land is essential. Sound property tax policies should pursue equity and neutrality in the interests of greater economic unity.

Crown Priorities

To obtain payment of arrears of taxes ahead of a taxpayer's other creditors, governments may draw from a formidable array of legal techniques.

Common law prerogative At common law, the Crown has the right to prior payment of its tax claims over other debts of equal degree. This prerogative is enjoyed by the Crown in right of both federal and provincial governments. Where both the federal and provincial governments claim the prerogative over a fund, their claims rank pari passu, each

government being entitled to a pro rata share of the proceeds (equal cents on each dollar claimed).

Statutory lien or charge A federal or, more commonly, a provincial taxing statute may impose a lien or charge on a taxpayer's assets to secure arrears of taxes and to confer on the government as lienholder priority in payment ahead of the taxpayer's other secured or unsecured creditors. Provincial and municipal governments may compete between and even within themselves, one lienholding arm of government vying with another for priority.

Statutory trust Federal and provincial tax statutes may impress a deemed trust on tax monies which were or should have been collected on behalf of the Crown and were not remitted to it, to confer upon the Crown beneficial ownership of the tax funds. For example, the federal government may claim a trust against an insolvent employer's estate to collect employee income tax withholdings. The provincial government may claim a trust against an insolvent merchant's assets for sales taxes.

Various procedural techniques Although these techniques do not of themselves confer a right of priority on the Crown, they create a short-cut remedy to give it an advantage over other creditors of the taxpayer who are "handicapped" by slower legal processes, such as the requirement to obtain a judgment or an order of foreclosure.

Certificate: the taxing statute authorizes the government to issue an official certificate assessing the tax owing by the taxpayer and upon registration in the court registry, it takes effect as a money judgment and may be enforced by execution against the taxpayer's assets.

Third party demand: the taxing statute authorizes the Crown to issue an order garnishing or attaching a debt owed to a delinquent taxpayer by a third party, requiring that party to pay the amount of the debt or enough of it to satisfy the tax arrears to the government. A third party who does not comply with the demand, without legal justification, becomes personally liable to pay that amount to the government.

Distress: a taxing statute may authorize the government to take possession, without legal process, of the tangible personal property of a delinquent taxpayer and to sell it in satisfaction of tax arrears.

Clearance certificate: a taxing statute may impose upon a trustee, personal representative, receiver or other fiduciary, the duty to obtain a government certificate that all taxes have been paid before distributing assets held in trust and, if the certificate is not obtained, the fiduciary is personally liable to the government for unpaid taxes up to the value of assets distributed.

The need for reform has been emphasized over and over in the reports of law reform commissions in Canada[290] and throughout the Commonwealth.[291] Crown prerogative, statutory liens, deemed trusts and the procedural devices violate the practicality, equity, and neutrality criteria and the claim that they serve the adequacy criterion is debatable. The consensus of these reports is that the Crown should usually rank as an ordinary unsecured creditor and that effective reform requires federal and provincial action.

Comparative Provincial Tax Rates

To complete our discussion of taxation policy and the Canadian economic union, we should compare the provincial tax rates. If the rates are similar, they may tend to minimize interference with the free movement of persons, goods and capital throughout the country. Conversely, wide disparities among the rates may violate the neutrality criterion. The rates do show considerable disparities, Alberta and the Territories imposing lower rates and the Atlantic provinces imposing higher ones. (See Table 4-2.)

Conclusions and Recommendations

In this paper, we have discussed many issues of taxation policy relating to the Canadian economic union. We examined the federal and provincial taxing powers and the constitutional foundations of the economic union. We then identified the primary criteria of a good tax or tax system as adequacy, practicality, equality, redistribution of wealth, neutrality, economic stability and political order, applying them to various tax policy issues, and recommending that investigative powers in revenue statutes should be reformed. We concluded that equity and neutrality were probably the most important criteria. We then appraised federal and provincial taxes and recommended specific reforms in the following areas: (1) income tax — expanding and rationalizing the exemptions of fringe benefits for employees working at special or remote work sites and at northern or isolated posts; and increasing the deductibility of investigatory and feasibility expenses; (2) provincial sales tax — abolishing the double taxation of extra-provincial trade-in purchases; enacting apportionment rules in statutory or regulatory form; eliminating tax barriers to construction contractors, settlers, migrants and business proprietors; (3) Crown priorities — general abolition, at the federal and provincial levels. We also made other more general observations about (1) corporate income tax–provincial allocation rules; (2) gift and succession duty; (3) provincial natural resource tax rates; (4) provincial corporate capital taxes; and (5) provincial and municipal property taxes.

TABLE 4-2 Provincial Tax Rates 1984

	Personal Income Tax	Corporate Income Tax		Sales Tax	Corporate Capital Tax[j]		
		General	Small Business[h]		General	Banks	Trust/Loan
				(percent)			
British Columbia	44.0[a]	16	8	7	0.2	0.8 or 2.0[k]	0.6
Alberta	43.5	11	5	—	—	—	—
Saskatchewan	51.0[b]	16	10[l]	5	0.3	0.8	0.8
Manitoba	54.0[c]	16	10	6	0.2	2.0	0.6
Ontario	48.0[d]	15[f]	10[i]	7	0.3	0.8	0.6
Quebec	N/A[e]	13[g]	3	9	0.45	0.9	0.9
New Brunswick	56.5	14	9	10	—	—	—
Prince Edward Island	52.5	10	10	10	—	—	—
Nova Scotia	56.5	15	10	10	—	—	—
Newfoundland	60.0	16	10	12	—	1.5	1.5
Yukon Territory	43.0	10	10	—	—	—	—
Northwest Territories	43.0	10	10	—	—	—	—

Source: Derived from Price Waterhouse, *Doing Business in Canada* (1983), pp. 179–80, 191.

a. British Columbia imposes a surtax of 10% on provincial tax in excess of $3,500.
b. Saskatchewan imposes a surtax of 12% on provincial tax in excess of $4,000.
c. Manitoba imposes a surtax of 20% of the provincial tax on taxable income in excess of $25,000.
d. Ontario imposes a surtax of 5% of the provincial tax on taxable income in excess of $2,218.
e. Quebec has its own personal tax system requiring a separate calculation of taxable income tax rates from 13% to 33%. Quebec residents receive a special abatement against federal income tax in recognition of this arrangement.
f. The tax rate on profits from manufacturing and processing, farming, mining, logging and fishing operations carried on in Canada is 14%.
g. The tax rate on active businesses income is 5.5%.
h. Active businesses income eligible for the federal small business deduction.
i. For any three taxation years ending after May 13, 1982 and before May 14, 1985, income eligible for the federal small business deduction is exempt from Ontario corporate income tax. After May 14, 1985, a new enterprise incentive will exempt from Ontario corporate income tax the eligible small business income of corporations incorporated after May 13, 1982, for three years immediately after incorporation.
j. There are special rates or exemptions available to certain corporations or corporations with certain minimum amounts of taxable paid-up capital.
k. For banks with taxable amounts greater than $500 million.
l. From January 1, 1984 Saskatchewan exempts manufacturing and processing profits from provincial income tax.

Notes

This study was completed in January 1985. Throughout the paper, the law is stated as of that date.

1. 1 W. & M., (2nd Sess.), c. 2.
2. *Bowles v. Bank of England*, [1913] 1 Ch. 57, at pp. 84–85, 87–88.
3. *In re W.H. Brookfield Estate*, [1949] S.C.R. 329, at p. 339, [1949] CTC 59, at p. 68, [1949] 2 D.L.R. 153, at pp. 162.
4. *Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy Ltd.*, [1933] A.C. 168, at p. 175, [1933] 1 D.L.R. 82 at p. 85, [1932] 3 W.W.R. 639, at p. 642 (P.C.).
5. 30 & 31 Vict., c. 3.
6. *Constitution Act, 1982* as enacted by *Canada Act 1982* (U.K.), c. 11, Sch. B.
7. H.M.S.O. Cmnd. 5460, Royal Commission on the Constitution, 1969–1973, vol. 1, para. 502, p. 152.
8. *Constitution Act, 1867*, *supra*, note 5, s. 122.
9. *Supra*, note 1.
10. See *Constitution Act, 1867*, *supra*, note 5, s. 122.
11. *A.-G. B.C. v. McDonald Murphy Lumber Co. Ltd.*, [1930] A.C. 357, at p. 364, [1930] 2 D.L.R. 721, at p. 724, [1930] 1 W.W.R. 830, at p. 834 (P.C.).
12. *Bolton v. Masden* (1963), 110 C.L.R. 264 (Aust. H.C.). A commodity tax is a type of excise duty: *C.P.R. v. A.-G. Sask.*, [1952] 2 S.C.R. 231, at pp. 251–52, [1952] 4 D.L.R. 11, at pp. 26–27.
13. *Atlantic Smoke Shops Ltd. v. Conlon and A.-G. Can.*, [1943] A.C. 550, [1943] 4 D.L.R. 81, [1943] 3 W.W.R. 113, [1943] 2 All E.R. 393 (P.C.).
14. *Lynch v. Canada North-west Land Co.* (1891), 19 S.C.R. 204, 5 Cart. 427.
15. *Northwest Territories Act*, R.S.C. 1970, c. N-22; *Yukon Act*, R.S.C. 1970, c. Y-2.
16. *Caron v. The King*, [1924] A.C. 999, at pp. 1003–1004, [1924] 3 W.W.R. 417, at pp. 419–20, [1924] 4 D.L.R. 105, at pp. 107–108 (P.C.).
17. *Ibid.*; *Reference re Agricultural Products Marketing Act and Two Other Acts*, [1978] 2 S.C.R. 1198, at pp. 1233–34, 19 N.R. 361, at pp. 400–401, 84 D.L.R. (3d) 257, at p. 283.
18. Frank R. Scott, *Essays on the Constitution* (1977, University of Toronto Press), p. 294.
19. *Canadian Industrial Gas & Oil Ltd. v. Gov't of Sask. and A.-G. Sask.*, [1978] 2 S.C.R. 545, at pp. 581–82, [1977] 6 W.W.R. 607, at pp. 636–37, 18 N.R. 107, at pp. 140–41, 80 D.L.R. (3d) 449, at pp. 473–74. Although Dickson, J. dissented, Martland, J., for the majority, approved Dickson, J.'s approach.
20. (1884), 10 App.Cas. 141 (P.C.).
21. (1887), 12 App.Cas. 575 (P.C.).
22. *Kerr v. Provincial Treasurer of Alta. and A.-G. Alta.*, [1933] A.C. 710, at pp. 720–21, [1933] 3 W.W.R. 38, at p. 44 (P.C.).
23. The Task Force on Canadian Unity (Jean-Luc Pepin, John P. Robarts, Co-Chairmen), *A Future Together* (1979), p. 90.
24. *Re Mining and Mineral Rights Tax Act; Newfoundland and Labrador Corporation Limited and Javelin International Limited v. A.-G. Nfld. and A.-G. Alta. et al.* (1982), 138 D.L.R. (3d) 577, 43 N.R. 406, 38 Nfld. & P.E.I.R. 502, 108 A.P.R. 502 (S.C.C.).
25. *Canadian Industrial Gas & Oil Ltd. v. Gov't of Sask. and A.-G. Sask.*, *supra*, note 19.
26. Ibid., p. 603 (S.C.R.), p. 654 (W.W.R.), p. 159 (N.R.), p. 489 (D.L.R.).
27. A.J. Easson, *Tax Law and Policy in the EEC* (1980, Oceana Publications), para. 82, pp. 59–60.
28. Derived from Price Waterhouse and Company, *Doing Business in Canada* (1983), p. 83.
29. *Canadian Charter of Rights and Freedoms, Constitution Act, 1982* as enacted by *Canada Act, 1982* (U.K.), c. 11, Sch. B., Part I.

30. D.G. Creighton, "The Economic Objectives of Confederation," in John J. Deutsch, *The Canadian Economy: Selected Readings* (1965, Macmillan), pp. 449–50.
31. W.R. Lederman, *Continuing Canadian Constitutional Dilemmas* (1981, Butterworth), p. 363.
32. *Gold Seal Ltd. v. Dominion Express Co. and A.-G. Alta.* (1921), 62 S.C.R. 424, at p. 456, [1927] 3 W.W.R. 710, at p. 730, 62 D.L.R. 62, at p. 79.
33. Ibid., p. 470 (S.C.R.), p. 740 (W.W.R.), p. 89 (D.L.R.).
34. *Atlantic Smoke Shops Ltd. v. Conlon and A.-G. Can.*, *supra*, note 13.
35. *Cairns Construction Ltd. v. Gov't of Saskatchewan*, [1960] S.C.R. 619, 35 W.W.R. 241, 24 D.L.R. (2d) 1.
36. The *CIGOL* case, *supra*, note 19; John D. Whyte, "The Constitution and National Resource Revenues," Institute of Intergovernmental Relations, Queen's University, Discussion Paper No. 14 (1982); also published in Charles E. McLure, Jr. and Peter Mieszkowski (eds.), *Fiscal Federalism and the Taxation of Natural Resources*: 1981 Tred Conference (1982, Lexington), pp. 205–35; Arne Paus-Jenssen, "Resource Taxation and the Supreme Court of Canada: The CIGOL Case" (1979), 5 *Canadian Public Policy* 45.
37. *Gold Seal Ltd. v. Dominion Express Co. and A.-G. Alta.*, *supra*, note 32, p. 438 (S.C.R.), p. 731 (W.W.R.), pp. 80–81 (D.L.R.).
38. *Law Society of Upper Canada v. Skapinker*, May 3, 1984.
39. *Tai Sing v. Maguire* (1878), 1 B.C.R. (Pt. I) 101 (S.C.).
40. Ibid., p. 112.
41. *Regina v. Wing Chong* (1885), 1 B.C.R. (Pt.II) 150 (S.C.).
42. Ibid., p. 164.
43. *Canadian Charter of Rights and Freedoms*, *supra*, note 29, subsec. 32(2).
44. Peter W. Hogg, *Constitutional Law of Canada* (1977, Carswell), p. 414.
45. Ibid., pp. 355–62, discussing the doctrine.
46. *Supra*, note 29.
47. *Reference re Proposed Federal Tax on Exported Natural Gas*, [1982] 1 S.C.R. 1004, at p. 1042, [1982] 5 W.W.R. 577, at p. 610, 136 D.L.R. (3d) 385, at p. 416.
48. *Bank of Toronto v. Lambe*, *supra*, note 21.
49. *Murphy v. C.P.R. and A.-G. Can.*, [1958] S.C.R. 626, 15 D.L.R. (2d) 145, 78 C.R.T.C. 322.
50. *Great North Western Telegraph Co. v. Fortier* (1903), 12 Que. K.B. 405 (C.A.).
51. *Re Clearwater Well Drilling Ltd. and Min. of Finance of N.S.* (1982), 52 N.S.R. (2d) 418, 106 A.P.R. 418, 135 D.L.R. (3d) 142 (C.A.).
52. *Bank of Toronto v. Lambe*, *supra*, note 21, p. 585.
53. See Robin W. Boadway and Harry M. Kitchen, *Canadian Tax Policy* (1980, Canadian Tax Foundation), pp. 1–24; The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, Report of a Committee chaired by Professor J.E. Meade (1978, Allen and Unwin), pp. 7–23; Taxation Review Committee, *Full Report*, 31 January 1975 (Asprey Committee), pp. 11–21; *Report of the Royal Commission on Taxation* (1966) (Carter Commission), vol. 2, pp. 1–48; The Ontario Committee on Taxation (1967) (Smith Committee), vol. 1, pp. 1–34; Government of Quebec, *Report of the Royal Commission on Taxation* (1968) (Bélanger Commission), pp. 27–33; Douglas J. McCready, *The Canadian Public Sector* (1984, Butterworth), chs. 3, 4.
54. Joseph T. Sneed, "The Criteria of Federal Income Tax Policy" (1965), 17 *Stan.L.Rev.* 567, is a very helpful analysis.
55. Carter Commission, *supra*, note 53, pp. 1–5.
56. G.V. La Forest, *The Allocation of Taxing Power under The Canadian Constitution* (2nd ed., 1981, Canadian Tax Foundation), p. 41; Hogg, *supra*, note 44, p. 80ff.
57. *Lawson v. Interior Tree Fruit and Vegetable Committee of Direction*, [1931] S.C.R. 357, at p. 364, [1931] 2 D.L.R. 193, at p. 198.

58. *A.-G. Alta. v. A.-G. Can.*, [1939] A.C. 117, [1938] 4 D.L.R. 433, [1938] 3 W.W.R. 337 (P.C.).
59. *Reference re Section 16 of the Special War Revenue Act*, [1942] S.C.R. 429, [1942] 4 D.L.R. 145.
60. *A.-G. B.C. v. A.-G. Can.*, [1924] A.C. 222, at p. 225, [1923] 4 D.L.R. 669, at p. 670, [1923] 3 W.W.R. 1249, at p. 1251 (P.C.).
61. *Proprietary Articles Trade Association v. A.-G. Can.*, [1931] A.C. 310, [1931] 2 D.L.R. 1, [1931] 1 W.W.R. 552, 55 C.C.C. 241 (P.C.).
62. *Reed v. Mousseau* (1883), 8 S.C.R. 408, at p. 430.
63. Section 118 of the *Constitution Act, 1867* (repealed by the *Statute Law Revision Act, 1950* (U.K.), 14 Geo. VI, c. 6) provided for subsidies to be paid by the federal government to the governments of Ontario, Quebec, Nova Scotia and New Brunswick in proportion to their respective populations according to the 1861 census. The present scheme is stated in the following statutes: the *Constitution Act, 1907* (U.K.), 7 Edw. VII, c. 11; *Provincial Subsidies Act*, R.S.C. 1970, c. P-26; *The Maritime Provinces Additional Subsidies Act*, S.C. 1942–43, c. 14; and the Terms of Union of Newfoundland with Canada, appended to *An Act to approve the Terms of Union of Newfoundland with Canada*, S.C. 1949, c. 1.
64. *Reed v. Mousseau*, *supra*, note 62; *Constitution Act, 1982*, *supra*, note 6, ss. 109 and 117; *Constitution Act, 1930* (U.K.), 21 Geo. V, c. 26.
65. *Reference re Proposed Federal Tax on Exported Natural Gas*, *supra*, note 47, pp. 1050, 1066 (S.C.R.) pp. 617, 631–32 (W.W.R.), pp. 422, 435 (D.L.R.).
66. Ibid., pp. 1065–66 (S.C.R.), p. 631 (W.W.R.), p. 434 (D.L.R.); see also *Reed v. Mousseau*, *supra*, note 62, p. 435.
67. Royal Commission on the Constitution, 1969–1973, *supra*, note 7, para. 517, p. 155.
68. The Hon. Allan J. MacEachen, *Federal-Provincial Fiscal Arrangements in the Eighties* (1981, Department of Finance), pp. 8, 12.
69. The Hon. E.J. Benson, *The Taxing Powers and the Constitution of Canada* (1969, Government of Canada), pp. 30–32, 46–48; criticized by Claude E. Forget, *The Power of the Purse in a Revised Constitution: A Commentary on the Federal Constitutional Papers on Taxing Powers and the Federal Parliament's Power to Spend* (1970, Private Planning Association of Canada).
70. Task Force on Canadian Unity, *supra*, note 23, Recommendation 41, p. 127.
71. Albert S. Abel, *Towards a Constitutional Charter for Canada* (1980, University of Toronto Press), ch. 3.
72. D.G. Davies, *International Comparisons of Tax Structures in Federal and Unitary Countries* (1976, Australian National University, Centre for Research on Federal Financial Relations), p. 36, suggests that the Canadian provinces derive more revenue as a percentage of gross national product by indirect taxes than any other country. In other words, the courts have interpreted the provincial taxing power so broadly that the incapacity to impose indirect taxes is more theoretical than real.
73. Task Force on Canadian Unity, *supra*, note 23. Recommendation 20, p. 123, states: "Section 123 of the B.N.A. Act should be clarified in order to guarantee more effectively free trade between the provinces for all produce and manufactured goods and be extended to include services." See also Abel, *supra*, note 71, p. 35.
74. *The Queen v. B.C. Ry.*, [1981] CTC 110, 81 DTC 5089, 36 N.R. 369, affd[1979] 2 F.C. 122, [1979] CTC 56, 79 DTC 5020; additional reasons, [1980] 2 F.C. 336 (T.D.); see also *Nicholls and Robinson v. Cumming* (1877), 1 S.C.R. 395, at p. 409.
75. Asprey Committee, *supra*, note 53, para. 3.19, p. 15.
76. For a review of the Department of National Revenue's efficiency, see Michael H. Rayner, *Report of the Auditor General of Canada to the House of Commons* (1980), chs. 7, 8; for the corporate costs of paying taxes see Marion H. Bryden, *The Costs of Tax Compliance* (1961, Canadian Tax Foundation).
77. *Trenton (Town of) v. Dyer* (1895), 24 S.C.R. 474, at p. 477.
78. *In re Bowater's Nfld. Pulp & Paper Mills Ltd.*, [1950] S.C.R. 608, at p. 623, [1950] 4 D.L.R. 65, at p. 81.

79. *R. v. Leake* (1924), 27 O.W.N. 3 (H.C.); *R. v. Dominion Bakery* (1923), 54 O.L.R. 656 (C.A.).
80. Advisory Council for Inter-government Relations, Information Paper No. 9, "Towards Adoptive Federalism" (1981), pp. 5–10, 44, 50.
81. Ibid., pp. 21, 25, 27, 32, 36–37, 50.
82. *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*, S.C. 1976–77, c. 10 as am.
83. "A Separate Personal Income Tax for Ontario," Ontario Economic Council *Position Paper* (1983), Part VII.
84. Alberta, White Paper, *Proposals for an Industrial and Science Strategy for Albertans 1985 to 1990* (1984), p. 63.
85. Ibid.
86. A. Breton and A. Scott, *The Economic Constitution of Federal States* (1978, University of Toronto Press); Richard M. Bird, *Federal Finance and Economic Union: A Perspective on Recent Canadian Discussion* (1983, University of Toronto, Department of Economics and Institute for Policy Analysis), pp. 18–19.
87. Asprey Committee, *supra*, note 53, para. 3.7, p. 12.
88. *Lynch v. The Canadian North-west Land Co.*, *supra*, note 14, p. 214 (S.C.R.); *Hudson's Bay Co. v. A.-G. Man.* (1878), Man.R. (Armour) 209, at p. 219 (Co.Ct.).
89. *Fortier v. Lambe* (1895), 25 S.C.R. 422.
90. Ibid., p. 429.
91. Ibid.
92. *Jonas v. Gilbert* (1880), 5 S.C.R. 356; *The King v. Marchioness of Donegal et al.* (1923), 51 N.B.R. 309, at 318, [1924] 2 D.L.R. 1191, at p. 1197 (S.C.-A.D.).
93. *In re the Income Tax Act, 1932 and Procter and Gamble Company of Canada Limited*, [1937] 3 W.W.R. 680, at p. 682 (Sask. K.B.); *Cogswell v. Holland* (1888), 21 N.S.R. 155 (S.C.-A.D.), affd 17 S.C.R. 420 (*sub nom. O'Brien v. Cogswell*); see also, Charles MacNabb, "Equity in Income Tax Cases" (1980), 28 *Can. Tax J.* 445.
94. *Partington v. A.-G.* (1869), L.R. 4 H.L. 100, at p. 122 (per Lord Cairns).
95. Carter Commission, *supra*, note 53, p. 19; Smith Committee, *supra*, note 53, para. 20, p. 8.
96. *Halifax (City of) v. Nova Scotia Car Works*, [1914] A.C. 992, at p. 998, 18 D.L.R. 649, at p. 652 (P.C.).
97. *In re the Income Tax Act, 1932*, *supra*, note 93.
98. *Thorne's Hardware Limited, et al. v. The Queen and National Harbours Board* (1983), 143 D.L.R. (3d) 577, at p. 589 (S.C.C.); cf. *Massey Ferguson Industries Ltd. v. Saskatchewan*, [1981] 2 S.C.R. 413, at p. 432, 127 D.L.R. (3d) 513, at p. 528, [1981] 6 W.W.R. 596, at p. 613; *Shannon v. Lower Mainland Dairy Products Board and A.-G. B.C.*, [1938] A.C. 708, [1938] 2 W.W.R. 604, [1938] 4 W.W.R. 81 (P.C.); *Ontario Boys' Wear Ltd. et al. v. The Advisory Committee et al.*, [1944] S.C.R. 349, at p. 359, [1944] 4 D.L.R. 273, at p. 280 (*Sub nom. Tolton Manufacturing Co. Ltd. v. The Advisory Committee et al.*); Richard M. Bird, *Charging for Public Services: A New Look at an Old Idea* (1976, Canadian Tax Foundation).
99. *Caron v. The King*, *supra*, note 16, p. 1006 (A.C.), p. 110 (D.L.R.), p. 422 (W.W.R.).
100. The Hon. E.J. Benson, *Proposals for Tax Reform* (1969, Department of Finance).
101. Ibid., para. 3.7, p. 37.
102. Ibid., paras. 3.10–12, pp. 37–38.
103. The Hon. E.J. Benson, *Summary of 1971 Tax Reform Legislation* (1971, Department of Finance), p. 30.
104. *Report of the Royal Commission on Corporate Concentration* (Robert W.V. Dickerson and Pierre A. Nadeau, Co-Chairmen (1978), pp. 274–76; criticized by Richard M. Bird, "Taxation: Much Ado About (Almost) Nothing," in *Perspectives on the Royal Commission on Corporate Concentration* (P.K. Gorecki, and W.T. Stanbury, eds.) (1979, Institute for Research on Public Policy).

105. White Paper, *supra*, note 84.
106. Department of Finance, *A Review of the Taxation of Capital Gains in Canada* (1980).
107. *Lower Mainland Dairy Products Sales Adjustment Committee v. Crystal Dairy Ltd.*, *supra*, note 4, p. 175 (A.C.), p. 85 (D.L.R.), p. 642 (W.W.R.).
108. *Reference re Proposed Federal Tax on Exported Natural Gas*, *supra*, note 47.
109. The provisions are quoted in full in "Canada is an Economic Union," *infra*. See Paul Davenport, "The Constitution and the Sharing of Wealth in Canada," in *Reshaping Confederation* (Paul Davenport and Richard H. Leach, eds.) (1984, Duke University Press).
110. Sally Pipes and Michael Walker, *Tax Facts* (3rd ed., 1982, Fraser Institute), p. 68.
111. Ibid., pp. 61–67.
112. E.g., Report of the Special Senate Committee on Poverty, *Poverty in Canada* (1971).
113. R.H.S. Crossman, *Paying for the Social Services* (1969, Fabian Society).
114. E.g., The Hon. W.A.C. Bennett, Opening Statement of the Province of British Columbia to the Federal-Provincial Conference (1971), p. 10. On behalf of the Progressive Conservative Party, the Hon. Robert L. Stanfield advocated the "Income Development Programme."
115. Crossman, *supra*, note 113, p. 16.
116. *Reference re Proposed Federal Tax on Exported Natural Gas*, *supra*, note 47, p. 1042 (S.C.R.), p. 610 (W.W.R.), p. 416 (D.L.R.).
117. Ibid., pp. 1074–75 (S.C.R.), pp. 638–39 (W.W.R.), p. 441 (D.L.R.).
118. Boadway and Kitchen, *supra*, note 53, pp. 201ff. (Citation in the original quotation).
119. Tax Foundation Inc., *Reconstructing the Federal Tax System* (1963), p. 21; see, generally, Joshua Mendelsohn and Carl E. Beigie, *Tax Concessions to Boost Investment: A Perspective* (1976, C.D. Howe Research Institute).
120. Neil Swan and A. Glynn, *The Costs and Benefits of Industrial Location Grants* (1977, Economic Council of Canada).
121. Walter H. Diamond and Dorothy B. Diamond, *Tax-Free Trade Zones of the World* (1978, M. Bender).
122. Stuart M. Butler, "Free Zones in the Inner City," in *Urban Economic Development* (Richard D. Bingham and John P. Blair, eds.) (1984, Sage Publishers).
123. Ibid.
124. Pierre Fortin, *Provincial Involvement in Regulating the Business Cycle: Justification, Scope and Terms* (1982, Economic Council of Canada).
125. *Re Anti-Inflation Act*, [1976] 2 S.C.R. 373, 9 N.R. 541, 68 D.L.R. (3d) 452.
126. *Anti-Inflation Act*, S.C. 1975, c. 75.
127. *Re Anti-Inflation Act*, *supra*, note 125, p. 445 (S.C.R.), pp. 606–607 (N.R.), p. 514 (D.L.R.).
128. E.J. Cooper, *Customs and Excise Law* (1984, Legal Books), para. 110, p. 6.
129. *Income War Tax Act, 1917*, S.C. 1917, c. 28.
130. *The Special War Revenue Act, 1915*, S.C. 1915, c. 8.
131. *Excise Tax Act*, R.S.C. 1970, c. E-13.
132. Ibid., Part V.
133. Ibid., Part III (jewellery), Part IV (playing cards and wines), Sch. 1 (automobiles and air conditioners).
134. McCready, *supra*, note 53, p. 280.
135. The economic difference between the VAT and RST has been described as "cosmetic": Paul R. McDaniel, "A Value Added Tax for the United States? Some Preliminary Reflections" (1980), 6 *J. Corp. L.* 15, at p. 38.
136. Carter Commission, *supra*, note 53, vol. 5, Part A, p. 53; summarized in Eric Schiff, *Value-Added Taxation in Europe* (1973, American Enterprise Institute for Public Policy Research), ch. 4.
137. Federal Sales Tax Review Committee (Wolfe D. Goodman, Chairman) (1983).

138. *Supra*, note 135.
139. Price Waterhouse and Company, *Value Added Tax* (1979), pp. 93–94.
140. *Supra*, note 135, pp. 32–33.
141. Ibid., pp. 19–22.
142. *Supra*, note 139, p. 94.
143. Section 8 of the Charter, prohibiting unreasonable searches and seizures: *M.N.R. et al. v. Kruger*, [1984] CTC 506, 84 DTC 6478 (F.C.A.); *Vespoli v. The Queen*, [1984] CTC 519, 84 DTC 6489 (F.C.A.); *Re New Garden Restaurant & Tavern Ltd. et al. and Minister of National Revenue* (1983), 1 D.L.R. (4th) 256 (Ont. H.C.); but see *Re McLeod and Minister of National Revenue et al.* (1983), 146 D.L.R. (3d) 561 (F.C.-T.D.).
144. Carter Commission, *supra*, note 53, pp. 13–16.
145. [1977] 2 S.C.R. 576, [1976] 6 W.W.R. 61, 11 N.R. 222, 71 D.L.R. (3d) 1.
146. Ibid., p. 592 (S.C.R.), p. 74 (W.W.R.), p. 241 (N.R.), p. 12 (D.L.R.).
147. *Central Canada Potash Co. Ltd. v. Saskatchewan*, [1979] 1 S.C.R. 42, (1978) 88 D.L.R. (3d) 609, [1978] 6 W.W.R. 400, 23 N.R. 481.
148. Ibid., p. 76 (S.C.R.), p. 632 (D.L.R.), p. 428 (W.W.R.), p. 511–12 (N.R.).
149. *Air Canada v. A.-G. B.C.*, [1983] 6 W.W.R. 689 (B.C.C.A.).
150. *James Richardson & Sons, Limited v. M.N.R.*, [1984] CTC 345, 84 DTC 6325 (S.C.C.).
151. Manitoba Law Reform Commission, *Enforcement of Revenue Statutes* (1979), p. 3; see also Kenneth R. McKinnon, "The *Charter* and Its Possible Impact on the Investigating Powers under the *Income Tax Act*" (1982/83), 8 *Queen's L.J.* 274; Daniel C. Nathanson, "The Canadian Charter of Rights and Freedoms, Recent Criminal Prosecution Policy, and the Access to Information Act," in *Report of Proceedings of the 35th Tax Conference* (1983, Canadian Tax Foundation), p. 636.
152. Manitoba Law Reform Commission, *supra*, note 151.
153. *Supra*, note 29, s. 8. See Kenneth A. Pye, "The Rights of Persons Accused of Crime under the Canadian Constitution: A Comparative Perspective," in *Reshaping Confederation* (Paul Davenport and Richard H. Leach, eds.) (1984, Duke University Press), pp. 240–42.
154. *M.N.R. et al. v. Kruger*, *supra*, note 143, p. 512 (CTC), p. 6483 (DTC).
155. Manitoba Law Reform Commission, *supra*, note 151; Committee on Enforcement Powers of the Revenue Departments (The Rt. Hon. The Lord Keith of Kinkel, Chairman, 1983, H.M.S.O. Cmnd. 8822), ch. 9.
156. Terrance Sandalow and Eric Stein (eds.), *Courts and Free Markets* (1982, Oxford University Press); Easson, *supra*, note 27; Carl S. Shoup (ed.), *Fiscal Harmonization in Common Markets* (1967, Columbia University Press).
157. Wayne R. Thirsk, "Tax Harmonization and Its Importance in the Canadian Federation," in *Fiscal Dimensions of Canadian Federalism* (Richard M. Bird, ed.) (1980, Canadian Tax Foundation).
158. The Task Force on Canadian Unity, *supra*, note 23.
159. *Fiscal Federalism in Canada*, Report of the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements (1981).
160. Gouvernement du Québec, *Québec-Canada: A New Deal* (1979); Government of Canada, *Sovereignty-Association: The Contradictions* (1978).
161. For recent economic perspectives on constitutional reform, see: Advisory Council for Inter-government Relations, *supra*, note 80; Breton and Scott, *supra*, note 86.
162. The Hon. Allan J. MacEachen, *supra*, note 68, p. 31.
163. Wayne R. Thirsk, "Fiscal Harmonization in the United States, Australia, West Germany, Switzerland, and the EEC," in *Federalism and the Canadian Economic Union* (M.J. Trebilcock, et al., eds.) (1983, University of Toronto Press for the Ontario Economic Council), p. 425.
164. Bird, *supra*, note 86.

165. Bélanger Commission, *supra*, note 53, p. 28.
166. Carter Commission, *supra*, note 53, p. 19.
167. Smith Committee, *supra*, note 53, para. 20, p. 8.
168. Meade Committee, *supra*, note 53, p. 23.
169. Asprey Committee, *supra*, note 53, para. 3-27, p. 17.
170. Boris I. Bittker, "Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities?" (1979), 16 *San Diego L. Rev.* 735.
171. Income tax is a direct tax: *City of Halifax v. Fairbanks Estate*, [1928] A.C. 117, at p. 125, [1927] 4 D.L.R. 945, at pp. 949–50, [1927] 3 W.W.R. 493, at p. 498 (P.C.)
172. *Supra*, note 82; David B. Perry, "The Federal-Provincial Fiscal Arrangements for 1982–87" (1983), 31 *Can. Tax J.* 30.
173. Ontario Economic Council, *supra*, note 83, p. xvii.
174. *Income Tax Act*, R.S.C 1952, c. 148 as am.; S.C. 1970–71–72, c. 63, subsecs.2(1), (3).
175. Ibid. para. 120(4)(a); Income Tax Regulations, subsecs. 2600(1), 2601(1); *Income Tax Act*, R.S.B.C. 1979, c. 190, para. 3(1)(a); *Alberta Income Tax Act*, R.S.A. 1980, c. A-31, cl. 2(1)(a); *The Income Tax Act*, R.S.S. 1978, cl. 2(1)(a); *The Income Tax Act* (Manitoba), R.S.M. 1970, c. I-10, cl. 3(1)(a); *Income Tax Act*, R.S.O. 1980, c. 213, cl. 2(a); *Taxation Act*, R.S.Q. 1977, c. I-3, s. 22; *Income Tax Act*, R.S.N.B. 1973, c. I-2, subsec. 2(1); *Income Tax Act*, R.S.N.S. 1967, c. 134, cl. 1(a); *Income Tax Act*, R.S.P.E.I. 1974, c. I-1, cl. 3(1)(a); *Income Tax Act*, R.S.N. 1970, c. 163; *Income Tax Act*, O.Y.T., 1979 (2nd), c. 7, para. 3(1)(a); *Income Tax Ordinance*, O.N.W.T. 1977 (3rd) c. 1, s. 3(1)(a).
176. *Income Tax Act*, *supra*, note 174, para. 120(4)(c) requires the taxpayer to add back to federal tax deductions for: foreign tax credit, investment tax credit, provincial logging taxes and contributions to registered political parties and candidates.
177. *Taxation Act* (Que.), *supra*, note 175, subsecs. 1000(1), (2)(e).
178. *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977*, *supra*, note 82, s. 7; *Income Tax Act*, *supra*, note 174, para. 150(1)(d).
179. *Income Tax Act* (B.C.), *supra*, note 175, s. 59; *Alberta Income Tax Act*, s. 62; *The Income Tax Act* (Sask.) s. 58; *The Income Tax Act* (Man.), s. 58; *Income Tax Act* (Ont.), s. 55, *Taxation Act* (Que.), ss. 1020–4; *Income Tax Act* (N.B.), s. 54; *Income Tax Act* (N.S.), s. 54; *Income Tax Act* (P.E.I.), s. 56; *Income Tax Act* (Nfld.), s. 56; *Income Tax Act* (Yukon), s. 57; *Income Tax Ordinance* (N.W.T.), s. 57.
180. *Income Tax Act* (B.C.), *supra*, note 175, s. 58; *Alberta Income Tax Act*, s. 61; *The Income Tax Act* (Sask.), s. 57; *The Income Tax Act* (Man.), s. 57; *Income Tax Act* (Ont.), s. 54; *Income Tax Act* (N.B.), s. 53; *Income Tax Act* (N.S.), s. 53; *Income Tax Act* (P.E.I.), s. 55; *Income Tax Act* (Nfld.), s. 55; *Income Tax Act* (Yukon), s. 57; *Income Tax Ordinance* (N.W.T.), s. 57.
181. *Income Tax Act*, *supra*, note 174.
182. *Charun v. M.N.R.*, [1983] CTC 2861, at p. 2684, 83 DTC 623, at p. 626 (Tax Ct. Can.).
183. *Taxation Act* (Que.), *supra*, note 175, subsec. 42(4) should also be amended for the same reason.
184. R.S.C. 1970, c. F-10, s. 17.
185. Order in Council P.C. 1980-1717, June 26, 1980, as am. by P.C. 1980-2948, October 30, 1980 and P.C. 1983-299, February 3, 1983.
186. R.M. Bird and N.E. Slack, "The Taxation of Northern Allowances" (1983), 31 *Can. Tax J.* 783.
187. Department of Finance, Release, "Tax Remission Extended for Housing and Travel Benefits in the North", December 9, 1983, 83-184.
188. The Hon. Michael H. Wilson, Economic Statement, November 8, 1984 (Richard De Boo), pp. 1–3.
189. The latest release does not refer to this aspect of the previous release.
190. Bird and Slack, *supra*, note 186.

191. The Minister of Finance has announced that the Department will review the exemptions, *supra*, note 188.

192. *Supra*, note 172.

193. *Van Buren Bridge Co. v. Madawaska and A.-G. N.B.* (1958), 41 M.P.R. 360, at p. 376, 15 D.L.R. (2d) 763, at p. 776 (N.B.S.C.-A.D.). However, a taxpayer has standing to enforce the agreement: *Alworth Jr. v. A.-G. B.C.* (1959), 20 D.L.R. (2d) 544, at p. 554 (B.C.S.C.), varied on appeal, (1960), 24 D.L.R. (2d) 71 (B.C.C.A.).

194. *Fiscal Federalism in Canada*, *supra*, note 159, pp. 183–84, quoting The Hon. Allan J. MacEachen, Minister of Finance, *supra*, note 68, pp. 31–32.

195. Sohrab Abizadeh and Richard Hudson, "Trends in the Federal Provincial Tax Collection Agreements: The Case of Alberta" (1983), 31 *Can. Tax J.* 653, at pp. 657–58; Ontario Economic Council, *supra*, note 83, pp. 115, 163.

196. *Taxation Act* (Que.), *supra*, note 175, ss. 965.1–.28.

197. Helmut Birk, "Quebec Stock Savings Plan," in *Report of Proceedings of the 31st Tax Conference* (1979, Canadian Tax Foundation), p. 524.

198. *Income Tax Act* (B.C.), *supra*, note 175, s. 4.1, to be proclaimed.

199. Ibid., s. 8.2.

200. *Housing and Employment Development Financing Act*, S.B.C. 1982, c. 34.

201. Ibid., s. 3.

202. *Income Tax Act* (B.C.), *supra*, note 175, subsec. 8(2).

203. Ibid., subsec. 8(5).

204. Ibid., subsec. 8(6).

205. Ontario Economic Council, *supra*, note 83, pp. 17, 26–27.

206. *Income Tax Act* (B.C.) *supra*, note 175, subsec. 5(2); *The Income Tax Act* (Sask.), subsec. 6(3); *The Income Tax Act* (Man.), subsec. 5(2); *Income Tax Act* (N.B.), subsec. 3(3); *Income Tax Act* (N.S.), subsec. 3(4); *Income Tax Act* (P.E.I.), subsec. 5(3); *Income Tax Act* (Nfld.), subsec. 5(3); *Income Tax Act* (Yukon), para. 4(4)(a); *Income Tax Ordinance* (N.W.T.), para. 4(4)(a).

207. *Alberta Corporate Income Tax Act*, R.S.A. 1980, c. A-17; *Corporations Tax Act*, R.S.O. 1980, c. 97; *Taxation Act* (Que.), *supra*, note 175, passim.

208. *Income Tax Act*, *supra*, note 174, subsecs. 127(5)–(12.2).

209. Ibid., paras. 127(9)(b)–(g).

210. *Taxation Act* (Que.), *supra*, note 175, ss. 773–75; *An Act respecting Corporations for the Development of Quebec Business Firms*, R.S.Q. 1977, c. S-28.

211. Ibid.

212. *Small Business Development Corporations Act*, R.S.O. 1980, c. 475.

213. Ibid., s. 22.

214. *The Venture Capital Tax Credit Act*, S. S. 1983–84, c. V-4.1, proclaimed in force effective June 29, 1984.

215. The Hon. Allan J. MacEachen, *supra*, note 68, p. 31.

216. *Income Tax Act*, *supra*, note 174, para. 120(4)(a); Income Tax Regulations, subsec. 2600(3); *Income Tax Act* (B.C.), *supra*, note 175, para. 2(1)(b), subsec. 3(6); *Alberta Income Tax Act*, cls. 2(1)(b), 3(4)(a); *The Income Tax Act* (Sask.) cls. 2(1)(b), 3(6)(b); *The Income Tax Act* (Man.), cls. 3(1)(b), 4(4)(b); *Income Tax Act* (Ont.), cls. 2(b), 3(6)(b); *Taxation Act* (Que.), ss. 25, 1088; *Income Tax Act* (N.B.), subsecs. 2(2)(b),(4); *Income Tax Act* (N.S.), cls. 1(1)(b), 2(4)(b); *Income Tax Act* (P.E.I.), cls. 3(1)(b), 4(4)(b); *Income Tax Act* (Nfld.), cls. 3(1)(b), 4(4)(b); *Income Tax Act* (Yukon), paras. 3(1)(b), 4(4)(a); *Income Tax Ordinance* (N.W.T.), paras. 3(1)(b), 4(4)(a).

217. *Income Tax Act*, *supra*, note 174, para. 120(4)(a); Income Tax Regulations, subsecs. 402(1), (2); *Income Tax Act* (B.C.), *supra*, note 175, subsec. 2(2); *Alberta Income Tax Act*, subsec. 2(2); *Alberta Corporate Income Tax Act*, *supra*, note 207, subsec. 5(1); *The Income Tax Act* (Sask.), *supra*, note 175, subsec. 2(2); *The Income Tax Act* (Man.), subsec. 3(3); *Corporations Tax Act* (Ont.), *supra*, note 207, s. 2; *Taxation Act* (Que.), *supra*, note 175, s. 22; *Income Tax Act* (N.B.), subsec. 1(2); *Income Tax Act*

(N.S.), subsec. 1(3); *Income Tax Act* (P.E.I.), subsec. 3(2); *Income Tax Act* (Nfld.), subsec. 3(3); *Income Tax Act* (Yukon), subsec. 3(2); *Income Tax Ordinance* (N.W.T.), subsec.3(2).

218. Income Tax Regulations, subsecs. 400(2) (corporations), 2600(2) (individuals).
219. *Alberta Corporate Income Tax Act*, *supra*, note 207, cl. 1(f).
220. *Corporations Tax Act*, *supra*, note 207, subsec. 5(1) includes agencies within the definition of permanent establishment.
221. *Taxation Act* (Que.), *supra*, note 175, s. 12 includes an office, etc., which is not a fixed or main place of business within the definition of establishment. Section 16.1 provides that a corporation not resident in Canada has an establishment in Quebec if it operates a mine, produces, processes, preserves, packs or builds goods or a product in whole or in part, or produces or presents a public show, within the province.
222. Income Tax Regulations, subsecs. 402(3) (corporations), 2603(3) (individuals).
223. Government of Alberta, "Basic Objectives and Terms of Reference for Alberta Business Taxation and Incentives," January 29, 1975 quoted in *Alberta Taxation Service* (1980, Richard De Boo), pp. 3–7, 3–8.
224. Ibid.: Peggy Cuciti et al., "State Energy Revenues," in *Fiscal Federalism and the Taxation of Natural Resources* (Charles E. Mclure, Jr. and Peter Mieszkowski, eds.), 1981 Tred Conference) (1982, Lexington Books), p. 22.
225. *Alberta Corporate Income Tax Act*, *supra*, note 207, s. 19.
226. Corporations Tax Regulations, R.R.O., 1980, Reg. 191, subsec. 302(3) as am.
227. *Taxation Act* Regulations, s. 22R5 (individuals), s. 771R3 (corporations).
228. *M.N.R. v. M.P. Drilling Ltd.*, [1976] CTC 58, 76 DTC 6028 (F.C.-A.D.).
229. Ibid., p. 63 (CTC), p. 6032 (DTC).
230. *Squires v. M.N.R.*, [1983] CTC 2409, 83 DTC 359 (T.R.B.).
231. *Income Tax Act*, *supra*, note 174, s. 14.
232. Under s. 14 there must be a business: subsec. 14(1), subsec. 14(5)(a); Interpretation Bulletin IT-143R2, Meaning of Eligible Capital Expenditure, August 10, 1983, para. 2(a).
233. Interpretation Bulletin IT-475, Expenditures on Research and for Business Expansion, March 31, 1981, para. F.
234. *Social Service Tax Act*, R.S.B.C. 1979, c. 388; *The Education and Health Tax Act*, R.S.S. 1978, c. E-3; *The Retail Sales Tax Act*, R.S.M. 1970, c. R150; *Retail Sales Tax Act*, R.S.O. 1980, c. 454; *Retail Sales Tax Act*, R.S.Q., c. I-1; *Social Services and Education Tax Act*, R.S.N.B. 1973, c. S-10; *Health Services Tax Act*, R.S.N.S. 1967, c. 126; *Revenue Tax Act*, R.S.P.E.I. 1974, c. R-14; *The Retail Sales Tax Act, 1978*, S.N. 1978, c. 36.
235. *Simpsons-Sears Ltd. v. New Brunswick, Provincial Secretary*, [1978] 2 S.C.R. 869, at p. 872, 18 N.R. 590, at p. 603, 20 N.B.R. (2d) 478, at p. 491, 34 A.P.R. 478, at p. 491.
236. Easson, *supra*, note 27, para. 82, p. 60.
237. *Social Service Tax Act* (B.C.), *supra*, note 234, subsecs. 2(4), 2.1(2); *The Education and Health Tax Act* (Sask.), subsecs. 5(9), (10); *The Retail Sales Tax Act* (Man.), cls. 2(1)(i), 4(1)(ii); *Retail Sales Tax Act* (Ont.), subsec. 2(14); *Retail Sales Tax Act* (Que.), s. 7; *Social Services and Education Tax Act* (N.B.), s. 8; *Health Services Tax Act* (N.S.), subsec. 5(1); *Revenue Tax Act* (P.E.I.), subsecs. 5(2), 7(2)–(4); *The Retail Sales Tax Act, 1978* (Nfld.), s. 16.
238. *Social Service Tax Act* (B.C.), *supra*, note 234, para. 4(1)(j); *The Education and Health Tax Act* (Sask.), cl. 8(1)(jj); *The Retail Sales Tax Act* (Man.), cl. 4(1)(aa); *Retail Sales Tax Act* (Ont.), para. 5(1)47; *Retail Sales Tax Act* (Que.), para. 17(r); *Social Services and Education Tax Act* (N.B.), para. 11(s), subsec. 11.3(2); *The Retail Sales Tax Act, 1978* (Nfld.), para. 20(i).
239. *Social Service Tax Act* (B.C.), *supra*, note 234, s. 39; *The Education and Health Tax Act* (Sask.), subsec. 18(1); *The Retail Sales Tax Act* (Man.), subsec. 26(2); *Retail Sales Tax Act* (Ont.), subsec. 2(8); *Retail Sales Tax Act* (Que.), s. 203; *Social Services and Education Tax Act* (N.B.), s. 51; *The Retail Sales Tax Act, 1978* (Nfld.), s. 21.

240. Economists doubt whether mail-order and cross-border sales are a serious avoidance problem: Thirsk, *supra*, note 157, pp. 135–36.

241. *A.-G. B.C. v. Kingcombe Navigation Co. Ltd.*, [1934] A.C. 45, [1933] 3 W.W.R. 353, [1934] 1 D.L.R. 31 (P.C.).

242. *R. v. Helfenstein*, [1981] 5 W.W.R. 571 (Alta. Prov. Ct.).

243. *Atlantic Smoke Shops Ltd. v. Conlon*, *supra*, note 13.

244. *Cairns Construction Ltd. v. Gov't. of Saskatchewan*, *supra*, note 35.

245. *R. v. Helfenstein*, *supra*, note 242.

246. *Health Services Tax Act*, *supra*, note 234, subsec. 8(2), repealed effective May 1, 1982.

247. Quoted in *Re Clearwater Well Drilling Ltd.* (1981), 124 D.L.R. (3d) 447, 46 N.S.R. (2d) 606, 89 A.P.R. 606 (N.S.S.C.-T.D.), rev'd. by (1982), 135 D.L.R. (3d) 142, 52 N.S.R. (2d) 418, 106 A.P.R. 418 (N.S.S.C.-A.D.).

248. Ibid.

249. Ibid., p. 153 (135 D.L.R.), p. 430 (52 N.S.R.), p. 430 (106 A.P.R.).

250. *Quality Construction Co. Ltd. v. Manitoba (Provincial Treasurer)*, [1971] 2 W.W.R. 161, 17 D.L.R. (3d) 603 (Man. C.A.); *Interprovincial Pipeline Ltd. v. The Queen in Right of Manitoba*, [1977] 6 W.W.R. 153 (Man. Q.B.).

251. *Bank of Toronto v. Lambe*, *supra*, note 21.

252. *Social Services and Health Tax Act*, *supra*, note 234, subsecs. 5.1(2), (3).

253. *Revenue Tax Act*, *supra*, note 234, subsec. 5(4).

254. *Health Services Tax Act*, *supra*, note 234, subsec. 5(2).

255. *Manitoba v. Air Canada*, [1980] 2 S.C.R. 303, [1980] CTC 428, 111 D.L.R. (3d) 513, 4 Man. R. (2d) 278, 32 N.R. 244, [1980] 5 W.W.R. 441; *Canadian Pacific Airlines Ltd. v. The Queen in right of B.C.*, [1983] 6 W.W.R. 48, 149 D.L.R. (3d) 519 (B.C.C.A.).

256. *Canadian Pacific Airlines Ltd.*, ibid.

257. *Manitoba v. Air Canada*, *supra*, note 255.

258. *Canadian Pacific Airlines Ltd. v. The Queen in right of B.C.*, *supra*, note 255.

259. Ibid., pp. 57–58 (W.W.R.), p. 528 (D.L.R.).

260. *Re Lynden Transport Inc. and Minister of Finance* (1981), 119 D.L.R. (3d) 765 (B.C.C.A.).

261. *Social Service Tax Act* Instructions, 17-3.

262. *Stickel v. M.N.R.*, [1972] CTC 210, 72 DTC 6178 (F.C.-T.D.), revd on other grounds, [1973] CTC 202, 73 DTC 5178 (F.C.-A.D.). They are admissible evidence as to the meaning of legislation: *Nowegijick v. The Queen* (1983), 144 D.L.R. (3d) 193, 83 CTC 20, 83 DTC 5041, 46 N.R. 41 (S.C.C.).

263. *Re Lynden Transport Inc. and Minister of Finance*, *supra*, note 256, p. 767.

264. (1961), 35 W.W.R. 264, 28 D.L.R. (2d) 441 (B.C.S.C.).

265. *British Columbia Taxation Service* (1984, Richard De Boo), p. 4–39.

266. Social Service Tax Regulations, B.C., Reg. 84/58, s. 3-12; *The Retail Sales Tax Act* (Man.), *supra*, note 234, cl. 4(1)(bb), Revised Regulation R150-R1, s. 1(22); *Social Services and Education Tax Act* (N.B.), para. 11 (mm); *Health Services Tax Act* (N.S.), cl. 10(1)(ac), Regulation 2(u).

267. *Retail Sales Tax Act*, *supra*, note 234, s. 5(1)(71), Regulation 903, s. 1-21.

268. *Taxation Act* (Que.), *supra*, note 175, ss. 1189–90; *Succession Duty Act*, S.Q. 1978, c. 37.

269. Wolfe D. Goodman, *International Double Taxation of Estates and Inheritances* (1978, Butterworth), pp. 31–41.

270. *Jodrey's Estate v. Nova Scotia*, [1980] 2 S.C.R. 774, 32 N.R. 257, 41 N.S.R. (2d) 181, 76 A.P.R. 181; *MacKeen Estate v. Nova Scotia* (1978), 89 D.L.R. (3d) 426, 28 N.S.R. (2d) 3, 43 A.P.R. 3 (N.S.S.C.-A.D.).

271. *A.-G. B.C. v. Canada Trust Co.*, [1980] 2 S.C.R. 466, 32 N.R. 326, [1980] 5 W.W.R. 591, 112 D.L.R. (3d) 592.

272. Goodman, *supra*, note 269, p. 33.

273. *Simpsons-Sears Ltd. v. New Brunswick, Provincial Secretary*, *supra*, note 235, p. 885 (S.C.R.) p. 615 (N.R.), p. 503 (N.B.R.), p. 503 (A.P.R.).

274. *The King v. Marchioness of Donegal et al.*, *supra*, note 92.

275. Task Force on Canadian Unity, *supra*, note 23, p. 90.

276. Thirsk, *supra*, note 157, p. 121.

277. *Corporation Capital Tax Act*, R.S.B.C. 1979, c. 69, s. 2; *The Corporation Capital Tax Act*, S.S. 1979–80, c. C-38.1, s. 3; *The Corporation Capital Tax Act*, S.M. 1976, c. 68, subsec. 6(1); *Corporations Tax Act*, R.S.O. 1980, c. 97, subsec. 2(1); *Taxation Act* (Que.), *supra*, note 175, s. 1130.

278. *The Financial Corporations Capital Tax Act*, S. Nfld. 1982, c. 8.

279. *Bank of Toronto v. Lambe*, *supra*, note 21.

280. Smith Committee, *supra*, note 53, paras. 114–25, pp. 111–15 (Vol. III); Bélanger Commission, *supra*, note 53, pp. 103–105.

281. Smith Committee, *supra*, note 53, para. 122, pp. 113–14.

282. Allan Taitz, *Corporation Capital Tax in Canada* (1980, CCH Canadian), para. 100, p. 2.

283. Smith Committee, *supra*, note 53, paras. 114–25, pp. 111–15 (Vol. III); Bélanger Commission, *supra*, note 53, pp. 103–105.

284. Bélanger Commission, *supra*, note 53, p. 105.

285. *Hudson Bay Co. v. A.-G. Man.*, *supra*, note 88.

286. *Morgan et al. v. A.-G. P.E.I. et al.*, [1976] 2 S.C.R. 349, 55 D.L.R. (3d) 527, 7 Nfld. & P.E.I.R. 537, 3 A.P.R. 537.

287. Ibid., pp. 358, 365 (S.C.R.), pp. 533, 539 (D.L.R.), pp. 545, 551 (Nfld. & P.E.I.R.), pp. 545, 551 (A.P.R.).

288. Easson, *supra*, note 27, para. 314, pp. 208–209.

289. *Re Minister of Revenue for Ontario and Hala et al.* (1977), 18 O.R. (2d) 88, 81 D.L.R. (3d) 710 (H.C.); but see Julio Menezes, "Economic Nationalism," in *Decade of Adjustment* (Julio Menezes, ed.), (1980, Butterworth), p. 92.

290. Law Reform Commission of British Columbia, *Report on the Crown as Creditor: Priorities and Privileges* (L.R.C. 57) (1982); Ontario Law Reform Commission, *Report on the Enforcement of Judgment Debts and Related Matters*, Part V (1983), pp. 27–29, 59–60; *Report of the Study Committee on Bankruptcy and Insolvency Legislation* (1970), p. 122ff.

291. Australian Senate Standing Committee on Constitutional and Legal Affairs, *Priority of Crown Debts* (1978); *Report of the Review Committee, Insolvency Law and Practice*, H.M.S.O. Cmnd. 8558 (1982), paras. 1467–70, pp. 332–33; Scottish Law Commission, *Report on Bankruptcy and Related Aspects of Insolvency and Liquidation*, No. 68 (1982), ch. 15.

Robin Boadway is Professor in the Department of Economics, Queen's University, Kingston.

Peter A. Cumming is Professor in the Osgoode Hall Law School, York University, Toronto.

Claude E. Forget is Associate Director of the C.D. Howe Research Institute, and a Partner in Société d'études et de changement organisationnels, Inc., Montreal.

Anthony F. Sheppard is Professor in the Faculty of Law, University of British Columbia, Vancouver.

THE COLLECTED RESEARCH STUDIES

Royal Commission on the Economic Union and Development Prospects for Canada

ECONOMICS

Income Distribution and Economic Security in Canada (Vol.1), *François Vaillancourt, Research Coordinator*

Vol. 1 Income Distribution and Economic Security in Canada, *F. Vaillancourt* (C)*

Industrial Structure (Vols. 2-8), *Donald G. McFetridge, Research Coordinator*

Vol. 2 Canadian Industry in Transition, *D.G. McFetridge* (C)
Vol. 3 Technological Change in Canadian Industry, *D.G. McFetridge* (C)
Vol. 4 Canadian Industrial Policy in Action, *D.G. McFetridge* (C)
Vol. 5 Economics of Industrial Policy and Strategy, *D.G. McFetridge* (C)
Vol. 6 The Role of Scale in Canada–US Productivity Differences, *J.R. Baldwin and P.K. Gorecki* (M)
Vol. 7 Competition Policy and Vertical Exchange, *F. Mathewson and R. Winter* (M)
Vol. 8 The Political Economy of Economic Adjustment, *M. Trebilcock* (M)

International Trade (Vols. 9-14), *John Whalley, Research Coordinator*

Vol. 9 Canadian Trade Policies and the World Economy, *J. Whalley with C. Hamilton and R. Hill* (M)
Vol. 10 Canada and the Multilateral Trading System, *J. Whalley* (M)
Vol. 11 Canada–United States Free Trade, *J. Whalley* (C)
Vol. 12 Domestic Policies and the International Economic Environment, *J. Whalley* (C)
Vol. 13 Trade, Industrial Policy and International Competition, *R. Harris* (M)
Vol. 14 Canada's Resource Industries and Water Export Policy, *J. Whalley* (C)

Labour Markets and Labour Relations (Vols. 15-18), *Craig Riddell, Research Coordinator*

Vol. 15 Labour-Management Cooperation in Canada, *C. Riddell* (C)
Vol. 16 Canadian Labour Relations, *C. Riddell* (C)
Vol. 17 Work and Pay: The Canadian Labour Market, *C. Riddell* (C)
Vol. 18 Adapting to Change: Labour Market Adjustment in Canada, *C. Riddell* (C)

Macroeconomics (Vols. 19-25), *John Sargent, Research Coordinator*

Vol. 19 Macroeconomic Performance and Policy Issues: Overviews, *J. Sargent* (M)
Vol. 20 Post-War Macroeconomic Developments, *J. Sargent* (C)
Vol. 21 Fiscal and Monetary Policy, *J. Sargent* (C)
Vol. 22 Economic Growth: Prospects and Determinants, *J. Sargent* (C)
Vol. 23 Long-Term Economic Prospects for Canada: A Symposium, *J. Sargent* (C)
Vol. 24 Foreign Macroeconomic Experience: A Symposium, *J. Sargent* (C)
Vol. 25 Dealing with Inflation and Unemployment in Canada, *C. Riddell* (M)

Economic Ideas and Social Issues (Vols. 26 and 27), *David Laidler, Research Coordinator*

Vol. 26 Approaches to Economic Well-Being, *D. Laidler* (C)
Vol. 27 Responses to Economic Change, *D. Laidler* (C)

* (C) denotes a Collection of studies by various authors coordinated by the person named. (M) denotes a Monograph.

Politics and institutions of government

Canada and the International Political Economy (Vols. 28-30), *Denis Stairs and Gilbert R. Winham, Research Coordinators*

Vol. 28 Canada and the International Political/Economic Environment, *D. Stairs and G.R. Winham* (C)
Vol. 29 The Politics of Canada's Economic Relationship with the United States, *D. Stairs and G.R. Winham* (C)
Vol. 30 Selected Problems in Formulating Foreign Economic Policy, *D. Stairs and G.R. Winham* (C)

State and Society in the Modern Era (Vols. 31 and 32), *Keith Banting, Research Coordinator*

Vol. 31 State and Society: Canada in Comparative Perspective, *K. Banting* (C)
Vol. 32 The State and Economic Interests, *K. Banting* (C)

Constitutionalism, Citizenship and Society (Vols. 33-35), *Alan Cairns and Cynthia Williams, Research Coordinators*

Vol. 33 Constitutionalism, Citizenship and Society in Canada, *A. Cairns and C. Williams* (C)
Vol. 34 The Politics of Gender, Ethnicity and Language in Canada, *A. Cairns and C. Williams* (C)
Vol. 35 Public Opinion and Public Policy in Canada, *R. Johnston* (M)

Representative Institutions (Vols. 36-39), *Peter Aucoin, Research Coordinator*

Vol. 36 Party Government and Regional Representation in Canada, *P. Aucoin* (C)
Vol. 37 Regional Responsiveness and the National Administrative State, *P. Aucoin* (C)
Vol. 38 Institutional Reforms for Representative Government, *P. Aucoin* (C)
Vol. 39 Intrastate Federalism in Canada, *D.V. Smiley and R.L. Watts* (M)

The Politics of Economic Policy (Vols. 40-43), *G. Bruce Doern, Research Coordinator*

Vol. 40 The Politics of Economic Policy, *G.B. Doern* (C)
Vol. 41 Federal and Provincial Budgeting, *A.M. Maslove, M.J. Prince and G.B. Doern* (M)
Vol. 42 Economic Regulation and the Federal System, *R. Schultz and A. Alexandroff* (M)
Vol. 43 Bureaucracy in Canada: Control and Reform, *S.L. Sutherland and G.B. Doern* (M)

Industrial Policy (Vols. 44 and 45), *André Blais, Research Coordinator*

Vol. 44 Industrial Policy, *A. Blais* (C)
Vol. 45 The Political Sociology of Industrial Policy, *A. Blais* (M)

Law and constitutional issues

Law, Society and the Economy (Vols. 46-51), *Ivan Bernier and Andrée Lajoie, Research Coordinators*

Vol. 46 Law, Society and the Economy, *I. Bernier and A. Lajoie* (C)
Vol. 47 The Supreme Court of Canada as an Instrument of Political Change, *I. Bernier and A. Lajoie* (C)
Vol. 48 Regulations, Crown Corporations and Administrative Tribunals, *I. Bernier and A. Lajoie* (C)
Vol. 49 Family Law and Social Welfare Legislation in Canada, *I. Bernier and A. Lajoie* (C)
Vol. 50 Consumer Protection, Environmental Law and Corporate Power, *I. Bernier and A. Lajoie* (C)
Vol. 51 Labour Law and Urban Law in Canada, *I. Bernier and A. Lajoie* (C)

The International Legal Environment (Vols. 52-54), *John Quinn, Research Coordinator*

Vol. 52 The International Legal Environment, *J. Quinn* (C)
Vol. 53 Canadian Economic Development and the International Trading System, *M.M. Hart* (M)
Vol. 54 Canada and the New International Law of the Sea, *D.M. Johnston* (M)

Harmonization of Laws in Canada (Vols. 55 and 56), *Ronald C.C. Cuming, Research Coordinator*

Vol. 55 Perspectives on the Harmonization of Law in Canada, *R. Cuming* (C)
Vol. 56 Harmonization of Business Law in Canada, *R. Cuming* (C)

Institutional and Constitutional Arrangements (Vols. 57 and 58), *Clare F. Beckton and A. Wayne MacKay, Research Coordinators*

Vol. 57 Recurring Issues in Canadian Federalism, *C.F. Beckton and A.W. MacKay* (C)
Vol. 58 The Courts and The Charter, *C.F. Beckton and A.W. MacKay* (C)

Federalism and the economic union

Federalism and The Economic Union (Vols. 58-72), *Mark Krasnick, Kenneth Norrie and Richard Simeon, Research Coordinators*

Vol. 59 Federalism and Economic Union in Canada, *K. Norrie, R. Simeon and M. Krasnick* (M)
Vol. 60 Perspectives on the Canadian Economic Union, *M. Krasnick* (C)
Vol. 61 Division of Powers and Public Policy, *R. Simeon* (C)
Vol. 62 Case Studies in the Division of Powers, *M. Krasnick* (C)
Vol. 63 Intergovernmental Relations, *R. Simeon* (C)
Vol. 64 Disparities and Interregional Adjustment, *K. Norrie* (C)
Vol. 65 Fiscal Federalism, *M. Krasnick* (C)
Vol. 66 Mobility of Capital in the Canadian Economic Union, *N. Roy* (M)
Vol. 67 Economic Management and the Division of Powers, *T.J. Courchene* (M)
Vol. 68 Regional Aspects of Confederation, *J. Whalley* (M)
Vol. 69 Interest Groups in the Canadian Federal System, *H.G. Thorburn* (M)
Vol. 70 Canada and Quebec, Past and Future: An Essay, *D. Latouche* (M)
Vol. 71 The Political Economy of Canadian Federalism: 1940-1984, *R. Simeon and I. Robinson* (M)

The north

Vol. 72 The North, *Michael S. Whittington, Coordinator* (C)

Commission Organization

Chairman

Donald S. Macdonald

Commissioners

Clarence L. Barber
Albert Breton
M. Angela Cantwell Peters
E. Gérard Docquier
William M. Hamilton
John R. Messer
Laurent Picard
Michel Robert
Daryl K. Seaman
Thomas K. Shoyama
Jean Casselman-Wadds
Catherine T. Wallace

Senior Officers

Executive Director
J. Gerald Godsoe

Director of Policy
Alan Nymark

Secretary
Michel Rochon

Director of Administration
Sheila-Marie Cook

Senior Advisors
David Ablett
Victor Clarke
Carl Goldenberg
Harry Stewart

Director of Publishing
Ed Matheson

Directors of Research
Ivan Bernier
Alan Cairns
David C. Smith

Co-Directors of Research
Kenneth Norrie
John Sargent

Research Program Organization

Economics

Research Director
David C. Smith

Executive Assistant & Assistant Director (Research Services)
I. Lilla Connidis

Coordinators
David Laidler
Donald G. McFetridge
Kenneth Norrie*
Craig Riddell
John Sargent*
François Vaillancourt
John Whalley

Research Analysts
Caroline Digby
Mireille Ethier
Judith Gold
Douglas S. Green
Colleen Hamilton
Roderick Hill
Joyce Martin

Politics and the Institutions of Government

Research Director
Alan Cairns

Executive Assistant
Karen Jackson

Coordinators
Peter Aucoin
Keith Banting
André Blais
Bruce Doern
Richard Simeon
Denis Stairs
Cynthia Williams
Gilbert R. Winham

Research Analysts
Claude Desranleau
Ian Robinson

Office Administration
Donna Stebbing

Law and Constitutional Issues

Research Director
Ivan Bernier

Executive Assistant & Research Program Administrator
Jacques J.M. Shore

Coordinators
Clare F. Beckton
Ronald C.C. Cuming
Mark Krasnick
Andrée Lajoie
A. Wayne MacKay
John J. Quinn

Administrative and Research Assistant
Nicolas Roy

Research Analyst
Nola Silzer

*Kenneth Norrie and John Sargent co-directed the final phase of Economics Research with David Smith